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**Lead Counsel**

UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF CALIFORNIA

Adrian G. Mongeli, Individually And On Behalf  
of All Others Similarly Situated,

Lead Plaintiff,

vs.

TERAYON COMMUNICATION SYSTEMS,  
INC., JERRY D. CHASE, RAY FRITZ,  
EDWARD LOPEZ, CAROL LUSTENADER,  
MATTHEW MILLER, ZAKI RAKIB,  
SHLOMO RAKIB, MARK A. RICHMAN,  
CHRISTOPHER SCHAEPE, MARK SLAVEN,  
LEWIS SOLOMON, HOWARD W. SPEAKS,  
ARTHUR T. TAYLOR, DAVID WOODROW,  
DOUG SABELLA and ERNST & YOUNG,  
LLP

Defendants.

Civil Docket No. 3-06-CV-3936 MJJ

DECLARATION OF KIM E. MILLER  
IN SUPPORT OF MEMORANDUM OF  
POINTS AND AUTHORITIES IN  
OPPOSITION TO MOTION OF  
TERAYON COMMUNICATION  
SYSTEMS AND INDIVIDUAL  
DEFENDANTS TO DISMISS  
AMENDED CLASS ACTION  
COMPLAINT

DATE: July 24, 2007  
TIME: 9:30 A.M.  
CTRM: 11, 9<sup>th</sup> Floor

I, Kim E. Miller, hereby declare as follows:

1. I am member of the law firm of Kahn Gauthier Swick, LLC.

2. I submit this Declaration, together with the attached exhibits, in further support of the Opposition to the Motion of Terayon Communication Systems and Individual Defendants to Dismiss Amended Class Action Complaint. I am fully familiar with the facts set forth herein.

3. Attached hereto as Exhibit A is a Chart regarding stock trends during three phases of fraud.

4. Attached hereto as Exhibit B is a true and correct copy of a January 24, 2005 article available at Globes online.

5. Attached hereto as Exhibit C are Actionable Statements in the Complaint, in context, that were identified by Defendants' Exhibit A as Puffery or protected by the Safe Harbor.

6. Attached hereto as Exhibit D is a true and correct copy of a Yahoo.Finance stock chart reflecting the prices for Company shares between October 18, 2005 and November 8, 2005.

7. Attached hereto as Exhibit E is a true and correct copy of a Yahoo.Finance stock chart reflecting the prices for Company shares between January 9, 2006 and January 17, 2006.

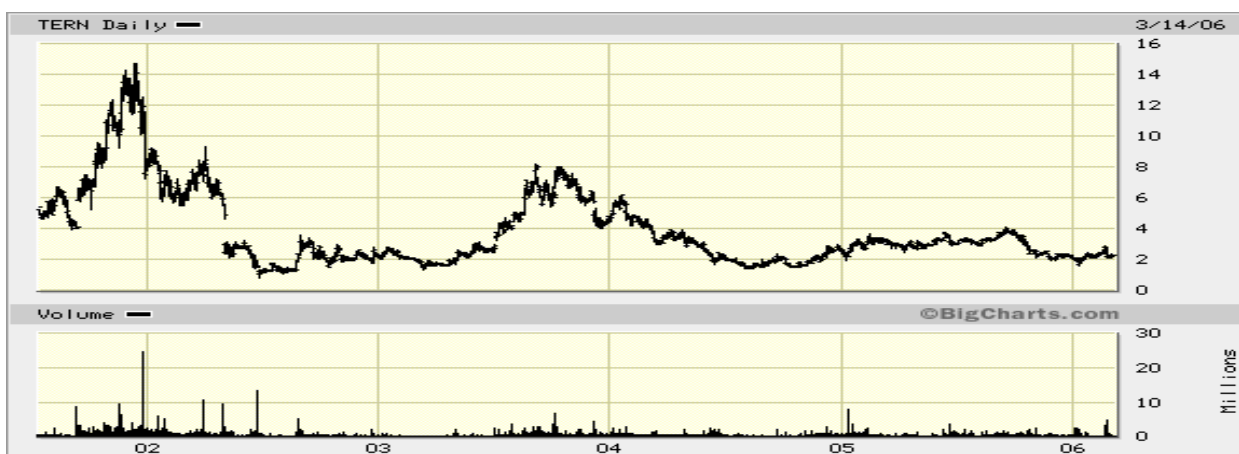
8. Attached hereto as Exhibit F is a true and correct copy of a Yahoo.Finance stock chart reflecting the prices for Company shares between March 1, 2006 and March 2, 2006.

I declare under penalty of perjury under the laws of the State of New York that the foregoing facts are true and correct.

Executed this 23<sup>rd</sup> day of April, 2007.

/s/ Kim E. Miller

Kim E. Miller



	I		I	
PHASE I	I	PHASE II	I	PHASE III
Transition	I	Restructuring	I	Resolution

PHASE I (“TRANSITION”) -- Defendants sought to restore credibility after being accused of prior stock fraud and illegal insider trading and after witnessing a dramatic decline in the price of Company shares. Defendants informed the market that the Company could not continue to operate as expected and that it was transitioning into a commodities-based products Company. At the end of phase I, the stock was flat. While retiring their own debt in phase I had improved the balance sheet, defendants believed they would be able to sell more securities and raise more money and therefore the Rakib brothers did not yet sell shares.

PHASE II (“RESTRUCTURING”): During phase II, by March 14, 2003, defendants announce a new restructuring plan that eventually became defendants’ focus on its CTMS and digital video sales. By concentrating on CMTS and digital video in early phase II, defendants were able to increase revenues from \$22.3M (reported at 1Q:03) to \$42M (by 1Q:04). Defendants reported record Digital Video Sales in 2Q:04 and 3Q:04. By the end of phase II, defendants recognized that their scheme to artificially-inflate the stock price was not working as

well as it had in phase I, where shares rallied from \$4.00 to \$14.00/share. During phase II, shares only rallied from \$2.00 to \$8.00/share – 43% lower than its previous trading high. This phase is also marked by upheaval of management as senior managers fled.

Phase III (“RESOLUTION/ BAIL OUT”): During phase III, CMTS is abandoned, and revenues fall back below \$30 million, *e.g.*, 4Q:04 (\$29.4M). By this point, the Company appeared to be reliant on a single product with limited growth potential. Defendants began to reveal serious control weakness and control deficiencies [*see* 4Q:04 10K, 1Q:05 10-Q, 2Q:05 10-Q]. At that time, however, defendants stated that weaknesses were remediated. During phase III, E&Y resigned on August 27, 2005 before the disclosures concerning the accounting problems, complete lack of controls, and the need for extensive Restatements began to be disclosed. Also during phase III, the Rakib brothers each sold 150,000 shares at \$3.50/share. Between mid-2004 and March 2006, Company stock only traded above \$3.50 on a handful of days.



13 of 19 DOCUMENTS

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Globes [online] - Israel's Business Arena

January 24, 2005 Monday

**LENGTH:** 212 words

**HEADLINE:** Terayon chair Zaki Rakib buys Israel's most expensive house;  
The home in Herzliya Pituah was sold for \$22 million by Austrian businessman Martin Schlaff.

**BYLINE:** Golan Hazani - "Yediot Ahronot"

**BODY:**

The "Yediot Ahronot" Hebrew daily reports that Israel's most expensive house was sold for over \$22 million. Austrian-Jewish businessman Martin Schlaff, one of the owners of the casino in Jericho, sold the luxury house, located on Galei Techelet St. in Herzliya Pituah, to Vivian and Zaki Rakib, among the founders and owners of Terayon Communications Systems (Nasdaq: TERN).

Schlaff is considered a confidant of a number of Israeli prime ministers, including Prime Minister Ariel Sharon, as well as leading figures in the Palestinian Authority. He bought the land for the house in the 1990s from the Canadian embassy in Israel for \$6.5 million. The house took five years to build. The garden is on a cliff overlooking the sea. The house itself occupies one dunam (0.25 acres), with a seawater pool nearby. The house is equipped with the most modern electronic devices, and also has an atomic bomb shelter.

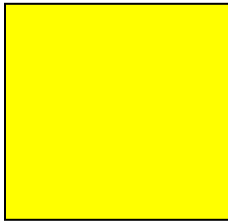
The house was put on the market over eighteen months ago, but Schlaff was unable to obtain the price he wanted. The Weissglas-Almagor law firm represented the sellers, Adv. Arie Hagai represented the buyers, and Adv. Yaakov Bardugo advised both parties.

Published by Globes [online]- [www.globes.co.il](http://www.globes.co.il) - on January 24, 2005

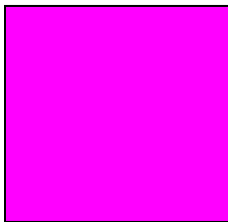
[www.globes.co.il](http://www.globes.co.il)

**LOAD-DATE:** February 1, 2005

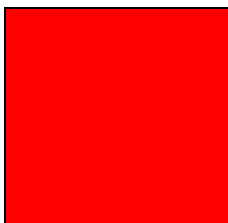
## **KEY**



Statements provided in Appendix A to Defendant's Motion to Dismiss: Non-Actionable Statements of Puffery or Corporate Optimism



Statements provided in Appendix B to Defendant's Motion to Dismiss: Forward-Looking Statements & Accompanying Cautionary Language



Statements which appear in both Appendix A And Appendix B to Defendant's Motion to Dismiss

1           59. Ernst & Young's statements contained in the Company's SEC filings during the  
2 Class Period were each materially false and misleading when made for the following reasons,  
3 among others:

4           \* Terayon's financial statements and operational reports were *not* true, accurate or  
5 reliable. To the contrary, the value of Terayon's net income, earnings per share,  
6 results, and shareholders' equity had been materially overstated and its loss  
7 contingencies materially understated.

8           \* Ernst & Young had certified Terayon's financial statements as being GAAP  
9 compliant when they were not. In truth, in violation of GAAP, defendants failed to  
10 make proper and timely adjustments to Terayon's stated reports. As a result, the  
11 Company's profitability was materially overstated and costs and expenses  
12 understated.

13           \* Terayon's internal financial accounting and disclosure controls were grossly  
14 inadequate an ineffective and had not been properly tested by Ernst & Young, so as  
15 to prevent material misrepresentation of the Company's financial results and  
16 conditions.

17           \* Terayon's internal control deficiencies were material and pervasive, and had not been  
18 corrected by management at any time during the Class Period. Ernst & Young failed  
19 to refute defendants' denials and omissions during the Class Period, as a means of  
20 explaining away the obvious material internal control deficiencies.

21                           **Defendants' Materially False and Misleading**  
22                           **Statements Made During the Class Period**

23   *June 28, 2001 Press Release*

24           60. On June 28, 2001, the inception of the Class Period, Terayon published a release  
25 announcing preliminary results for the second quarter ended June 30, 2001, which provides, in part,  
26 as follows:  
27  
28

1 *Terayon expects to report total revenues in the range of \$62 to \$65 million.*

2 *Excluding a \$30 to \$40 million charge, the company expects a preliminary pro*  
 3 *forma loss for the second quarter of 2001 in the range of \$0.38 to \$0.40 per*  
 4 *share....*

5 July 24, 2001 Press Release

6 61. On July 24, 2001, Terayon published a release announcing results for the second  
 7 quarter ended June 30, 2001. In addition to providing more financial information about the  
 8 Company, this release also quoted defendant Zaki Rakib, in part, as follows:

9 *Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading supplier of*  
 10 *broadband access systems, today reported revenues of \$65.7 million. Excluding a*  
 11 *charge of \$28.7 million for inventory related reserves and vendor cancellation*  
 12 *charges the pro forma net loss was \$25.8 million, or \$0.38 per share, for the*  
 13 *second quarter ended June 30, 2001....*

14 *Revenues for the second quarter of 2001 sequentially grew 22% to \$65.7 million,*  
 15 *up from \$54.0 million in the first quarter of 2001. Pro forma net loss in the first*  
 16 *quarter of 2001 was \$29.3 million, or \$0.43 per share.*

17 *"Given the challenging economic conditions, we are very pleased with our results*  
 18 *for the second quarter of 2001, and we are also optimistic about the quarter*  
 19 *ahead," said Zaki Rakib, chief executive officer of Terayon. [Emphasis added.]*

20 Form 10-Q for Second Quarter 2001

21 62. On or about August 14, 2001, defendants filed with the SEC the Company's Form  
 22 10-Q for the quarter ended June 30, 2001 ("2Q:01 Form 10-Q"), signed by defendant Fritz. In  
 23 addition to making substantially similar statements concerning the Company's operations as were  
 24 contained in the June 28, 2001 and July 24, 2001 releases, the 2Q:01 Form 10-Q also stated, in part,  
 25 the following:

26 *The accompanying consolidated financial statements have been prepared in*  
 27 *accordance with generally accepted accounting principles for interim financial*  
 28 *information .... In the opinion of management, all adjustments (consisting*  
 29 *primarily of normal recurring accruals) necessary for a fair presentation of the*  
 30 *financial statements at June 30, 2001 and for the three months and six months*  
 31 *ended June 30, 2001 and 2000 have been included. [Emphasis added.]*

32 63. The Company's 2Q:01 Form 10-Q also reported Terayon's "Liquidity and Capital  
 33 Resources," in part, as follows:

34 *At June 30, 2001, we had approximately \$250.9 million in cash and cash*  
 35 *equivalents, \$143.1 million in short-term investments and a \$2.5 million revolving*  
 36 *line of credit. ...*

1 *In July 2000, we issued \$500 million of 5% Convertible Subordinated Notes due in*  
2 *August 2007, resulting in net proceeds to us of approximately \$484.5 million. The*  
3 *notes are our general unsecured obligation and are subordinated in right of*  
4 *payment to all of our existing and future senior indebtedness and to all of the*  
5 *liabilities of our subsidiaries. The Convertible Notes are convertible into shares of*  
6 *our common stock at a conversion price of \$84.01 per share at any time on or after*  
7 *October 24, 2000 through maturity, unless previously redeemed or repurchased.*  
8 *Interest is payable semiannually. Debt issuance costs related to the notes were*  
9 *approximately \$15.5 million.*

10 In February 2001, we repurchased approximately \$195.6 million of the Convertible  
11 Subordinated Notes for \$68.5 million in cash, resulting in a pretax extraordinary gain  
12 of approximately \$121.5 million. *In addition, in July and August 2001, we*  
13 *repurchased approximately \$104.3 million of the Convertible Subordinated Notes*  
14 *for \$45.0 million in cash, resulting in a pretax extraordinary gain of*  
15 *approximately \$56.5 million.* [Emphasis added.]

16 64. The statements contained in Terayon's June 28, 2001 and July 24, 2001 release and  
17 those statements contained in the Company's 2Q:01 Form 10-Q, referenced above, were each  
18 materially false and misleading when made, and were known by defendants to be false at that time  
19 or were recklessly disregarded as such. for the following reasons, among others:

20 (a) At all times during the Class Period, Terayon's financial statements and operational  
21 reports were *not* true, accurate or reliable. In fact, Terayon's net income, earnings per share,  
22 reported results, and shareholders' equity had been materially overstated and its loss contingencies  
23 understated;

24 (b) At all times during the Class Period, unbeknownst to investors, the Individual  
25 Defendants had certified Terayon's financial statements as being GAAP compliant despite the fact  
26 that in truth the Company's profitability was materially overstated and costs and expenses  
27 understated, as a result of defendants' failure to make true disclosures regarding the Company's  
28 convertible note offering, and defendants' failure to make proper and timely adjustments to  
29 Terayon's stated financial reports;

30 (c) Throughout the Class Period, Terayon did not have adequate systems of internal  
31 operational or financial controls, and the Company's financial results or operational reports were *not*  
32 true, accurate or reliable. In truth, Terayon's internal financial accounting and disclosure controls  
33 were not adequate nor effective and failed to prevent material fraud in the presentation of the  
34 Company's financial results and condition;



1 (d) Throughout the Class Period, the Company's financial statements and reports were  
2 *not* prepared in accordance with GAAP and SEC rules;

3 (e) The Company did not properly account for deferred revenue and related cost of  
4 goods sold. For example, the Company did not sufficiently evaluate its video products and  
5 improperly accounted for them in accordance with the revenue recognition criteria in SAB 104  
6 when revenue should have been accounted for in accordance with the software revenue recognition  
7 principles under SOP 97-2 – which requires the Company to establish vendor specific objective  
8 evidence of fair value for each element within a multiple-element arrangement;

9 (f) In at least 2003, 2004, and 2005 the Company improperly recognized revenue for  
10 transactions where the Company did not properly apply SAB 101, as amended by SAB 104. The  
11 Company improperly recognized a deferred revenue liability and a deferred cost of goods sold asset,  
12 thereby overstating assets and liabilities, and during the Restatement determined that deferred  
13 revenues and deferred cost of goods should not be recognized for these transactions. As a result, the  
14 Company adjusted deferred revenues by \$1.6 million, \$1.0 million and \$0.9 million for the years  
15 ended 2003 and 2004 and the first two quarters of 2005, respectively, and adjusted deferred cost of  
16 goods sold by \$0.9 million, \$0.3 million, and \$0.6 million for the years ended 2003 and 2004 and  
17 for the first two quarters of 2005;

18 (g) The Company did not account for a significant transaction whereby it developed a  
19 broadcast platform based on its DM 6400 product to sell to its customer Thomson Broadcast. As a  
20 result, revenue was improperly and prematurely recognized in violation of SOP 97-2, and in  
21 violation of SOP 81-1, which sets forth criteria for completed contract recognition. As a result, \$7.8  
22 million of revenue previously recognized in 2004 and \$1.8 million related to direct development  
23 costs previously recognized from the fourth quarter of 2003 through the second quarter of 2005  
24 were also deferred and ultimately recognized in the quarter ended December 31, 2005;

25 (h) The Company made improper allowances for doubtful accounts until at least 2004;

26 (i) The Company did not effectively monitor and adjust reserves related to its  
27 restructuring charges during the Class Period. The Company also over accrued reserves related to  
28 legal fees, taxes and other liabilities owed to third-party vendors;

1 (j) The Company did not have adequate internal control over financial reporting,  
2 including: (i) insufficient controls related to identification, capture, and timely communication of  
3 financially significant information between certain parts of the organization and the accounting and  
4 finance department to enable accounting for transactions in a complete and timely manner; (ii) lack  
5 of sufficient personnel with technical accounting expertise in the accounting and finance department  
6 and inadequate review and approval procedures to prepare external financial statements in  
7 accordance with GAAP; (iii) failure to properly recognize revenue in accordance with GAAP,  
8 including revenue recognized in accordance with the following principles: Statement of Position  
9 ("SOP") 97-2, "Software Revenue Recognition;" Staff Accounting Bulletin ("SAB") No. 101,  
10 "Revenue Recognition," as amended by SAB 104; "Accounting for Performance of Construction  
11 Type and Certain Production-Type Contracts" (SOP 81-1); and Financial Accounting Standards  
12 Board, Emerging Issues Task Force (EITF) 00-21, "Accounting for Revenue Arrangements with  
13 Multiple Deliverables; (iv) improper use of estimates, including monitoring and adjustment  
14 balances related to certain accruals and reserves, including allowance for doubtful accounts, legal  
15 charges, license fees, restructuring charges, taxes, warranty obligations and fixed assets; (v) lack of  
16 sufficient analysis and documentation of the application of GAAP; and (vi) ineffective controls over  
17 the documentation, authorization and review of manual journal entries and ineffective controls to  
18 ensure the accuracy and completeness of certain general ledger account reconciliations conducted in  
19 connection with period end financial reporting; and

20 (k) The Company's Convertible Subordinated Notes contained several imbedded  
21 derivatives. First, the Notes contain a contingent put where in the event of any default by the  
22 Company, the Trustee or holders of at least 25% of the principal amount of the Notes outstanding  
23 may declare all unpaid principal and interest to be due and immediately payable. In fact, this  
24 provision was triggered and the Company was forced to pay off the entire principal amount for a  
25 total of \$65.6 million in the quarter ending March 31, 2006. This provision was not disclosed to  
26 investors and was affirmatively concealed from them from the beginning of the Class Period until a  
27 California newspaper revealed the truth in January of 2006, shortly before the end of the Class  
28 Period. Two additional embedded derivatives – an investor conversion option and a liquidated

1 damages provision – did not comply with SFAS 133, which requires that an embedded derivative  
 2 must be separated from its host contract (i.e., the Notes) and accounted for as a stand-alone  
 3 derivative if the economic characteristics and risks of the embedded derivative would not be  
 4 considered clearly and closely related to the host contract.

5 October 23, 2001 Press Release

6 65. On October 23, 2001, Terayon published a release announcing results for the third  
 7 quarter ended September 30, 2001. In addition to providing financial information about the  
 8 Company, this release also quoted defendant Zaki Rakib, in part, as follows:

9 *Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading supplier of*  
 10 *broadband access systems, today reported revenues of \$79.6 million. Excluding a*  
 11 *charge of \$6.4 million for inventory related reserves and vendor cancellation charges,*  
 12 *the pro forma net loss was \$21.2 million, or \$0.31 per share, for the third quarter*  
 13 *ended September 30, 2001 .... Revenues for the third quarter of 2001 grew to \$79.6*  
 14 *million, up from \$65.7 million in the second quarter of 2001. Pro forma net loss in*  
 15 *the second quarter 2001, excluding a charge of \$28.7 million for inventory related*  
 16 *reserves and vendor cancellation charges, was \$25.8 million, or \$0.38 per share.*

17 \*\*\*

18 "Given the challenging economic conditions, we are very pleased with our  
 19 achievements and results in the third quarter of 2001," said Zaki Rakib, chief  
 20 executive officer of Terayon. [Emphasis added.]

21 Form 10-Q for Third Quarter 2001

22 66. On or about November 14, 2001, defendants filed with the SEC the Company's  
 23 3Q:01 Form 10-Q for the quarter ended September 30, 2001 ("3Q:01 Form 10-Q"), signed by  
 24 defendant Lustenader. In addition to making substantially similar statements concerning the  
 25 Company's operations as were contained in Terayon's October 23, 2001 release, the 3Q:01 Form  
 26 10-Q also stated, in part, the following:

27 *The accompanying consolidated financial statements have been prepared in*  
 28 *accordance with generally accepted accounting principles for interim financial*  
 29 *information .... In the opinion of management, all adjustments (consisting*  
 30 *primarily of normal recurring accruals) necessary for a fair presentation of the*  
 31 *financial statements at September 30, 2001 and for the three months and nine*  
 32 *months ended September 30, 2001 and 2000 have been included.*  
 33 [Emphasis added.]

34 67. The Company's 3Q:01 Form 10-Q also reported Terayon's Liquidity and Capital  
 35 Resources, in part, as follows:



*In July 2000, we issued \$500 million of 5% Convertible Subordinated Notes due in August 2007, resulting in net proceeds to us of approximately \$484.5 million. The notes are our general unsecured obligation and are subordinated in right of payment to all of our existing and future senior indebtedness and to all of the liabilities of our subsidiaries. The Convertible Notes are convertible into shares of our common stock at a conversion price of \$84.01 per share at any time on or after October 24, 2000 through maturity, unless previously redeemed or repurchased. Interest is payable semiannually. Debt issuance costs related to the notes were approximately \$15.5 million.*

*In February 2001, we repurchased approximately \$195.6 million of the Convertible Subordinated Notes for \$68.5 million in cash, resulting in a pretax extraordinary gain of approximately \$121.5 million. In addition, in July and August 2001, we repurchased approximately \$104.3 million of the Convertible Subordinated Notes for \$45.0 million in cash, resulting in an extraordinary gain of approximately \$51.8 million. [Emphasis added.]*

68. The statements contained in Terayon's October 23, 2001 release and those statements contained in the Company's 3Q:01 Form 10-Q, referenced above, were each materially false and misleading when made and were known by defendants to be false at that time or were recklessly disregarded as such, for the reasons stated herein in ¶ 64.

January 28, 2002 Press Release

69. On January 28, 2002, Terayon published a release announcing results for the fourth quarter and full year ended December 31, 2001. In addition to announcing revenues of \$279 million for the year, this release stated, in part, the following:

*Terayon Communication Systems, Inc. (Nasdaq: TERN), the world's second largest provider of cable broadband modems and headends, today reported revenues of \$80.2 million for the fourth quarter 2001, an increase of 27% from \$62.9 million for the fourth quarter 2000.*

\* \* \*

*For the full fiscal year, revenues were \$279.5 million, down 18% compared to \$339.5 million for the previous year. Excluding \$33.5 million in special charges related to inventory reserves and vendor cancellation exposures, the pro forma loss in fiscal year 2001 was \$86.1 million or \$1.26 per share, compared to a full year 2000 pro forma loss of \$15.5 million or \$0.25 per share.*

\* \* \*

At the end of December 2001, cash and short-term investments were \$334 million. *The convertible debt outstanding at the end of December 2001 was \$174 million down from \$500 million as of December 2000.* The net cash position (cash less long term debt) improved to \$160 million compared to \$62 million at the end of 2000. [Emphasis added.]

70. The Company's January 28, 2002 release also quoted defendant Zaki Rakib, in part, as follows:

**"The key to success in 2001 was focus,"** said Dr. Zaki Rakib, Terayon CEO. "We focused on strengthening our financial position while continuing to invest in technology. Terayon realized a return on its efforts when the S-CDMA technology was included in the completed DOCSIS™ 2.0 specification issued in December 2001. This opened a new window of opportunity for us in the U.S. market. Eight of the top nine U.S. MSOs are currently in different stages of testing our new TJ 615 DOCSIS 2.0-based modem and one of the top three already has indicated its intent to deploy the modem shortly." [Emphasis added.]

#### 2001 10-K

71. On or about April 1, 2002, defendants filed with the SEC the Company's 2001 Form 10-K for the year ended December 31, 2001, signed by defendants Zaki Rakib, Lustenader, Shlomo Rakib, Schaepe, and Solomon. In addition to making substantially similar statements concerning the Company's operations as were contained in Terayon's January 28, 2002 release, the Company's 2001 Form 10-K also contained statements attesting to the "Critical Accounting Policies" that were purported to then be in place at Terayon, in part, as follows:

#### **Critical Accounting Policies**

We consider certain accounting policies related to revenue recognition, bad debt reserves, inventory reserves, impairment of long-lived assets, warranty returns and contingencies to be critical policies due to the estimation processes involved in each.

\* \* \*

**Revenue Recognition.** We recognize revenue in accordance with SEC Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB 101), as amended by SAB 101A and 101B. SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (4) is based on management's judgments regarding the collectibility of the selling price. Should changes in conditions cause management to determine these criteria are not met for certain future transactions, revenue recognized for any reporting period could be adversely affected.

\* \* \*

#### **Revenue Recognition**

The Company sells its products directly to broadband access service providers, system resellers and distributors and recognizes revenue upon shipment to the customer when title is transferred. *Revenues related to product sales are generally recognized when: (1) persuasive evidence that an arrangement exists, (2) delivery*

1 *has occurred or services have been rendered, (3) the seller's price to the buyer is*  
2 *fixed or determinable, and (4) collectibility is reasonably assured. The Company's*  
3 *existing agreements with its system resellers and distributors do not contain price*  
4 *protection provisions and do not grant return rights beyond those provided by the*  
5 *Company's standard warranty. [Emphasis added.]*

6 72. The Company's 2001 Form 10-K also reported on Terayon's Liquidity and Capital  
7 Resources, in part, as follows:

8 At December 31, 2001, we had approximately \$100.3 million in cash and cash  
9 equivalents and \$233.6 million in short-term investments.

10 *In July 2000, we issued \$500 million of Notes, resulting in net proceeds to us of*  
11 *approximately \$484.4 million. The Notes are our general unsecured obligation*  
12 *and are subordinated in right of payment to all of our existing and future senior*  
13 *indebtedness and to all of the liabilities of our subsidiaries. The Notes are*  
14 *convertible into shares of our common stock at a conversion price of \$84.01 per*  
15 *share at any time on or after October 24, 2000 through maturity, unless previously*  
16 *redeemed or repurchased. Interest is payable semiannually. Debt issuance costs*  
17 *related to the Notes were approximately \$15.6 million.*

18 *In 2001, we repurchased approximately \$325.9 million of the Notes for \$113.4*  
19 *million in cash and \$17.9 million in stock, resulting in an extraordinary gain of*  
20 *approximately \$185.3 million net of \$9.3 million of previously unamortized debt*  
21 *issuance costs. [Emphasis added.]*

22 January 28, 2002 Ernst & Young Report

23 73. For full year 2001, Ernst & Young charged the Company over \$500,000 in audit fees.  
24 In return for payment of these fees, Ernst & Young provided an audit of the Company's reported  
25 year-end financial results. After completing that review at year end 2001, Ernst & Young provided  
26 a report, dated January 28, 2002, to the Board of Directors and Stockholders of the Company that  
27 stated, in part, as follows:

28 *We have audited the accompanying consolidated balance sheets of Terayon*  
29 *Communication Systems, Inc. as of December 31, 2001 and 2000, and the related*  
30 *consolidated statements of operations, stockholders' equity, and cash flows for*  
31 *each of the three years in the period ended December 31, 2001.... Our*  
32 *responsibility is to express an opinion on these financial statements and schedule*  
33 *based on our audits.*

34 *We conducted our audits in accordance with auditing standards generally accepted*  
35 *in the United States.... In our opinion, the consolidated financial statements*  
36 *referred to above present fairly, in all material respects, the consolidated financial*  
37 *position of Terayon Communication Systems, Inc. at December 31, 2001 and 2000,*  
38



1 *and the consolidated results of its operations and its cash flows for each of the*  
 2 *three years in the period ended December 31, 2001, in conformity with accounting*  
 3 *principles generally accepted in the United States.* [Emphasis added.]

4 74. The statements made by defendants and contained in the Company's January 28,  
 5 2002 press release and in the 2001 Form 10-K, were each materially false and misleading and were  
 6 know by defendants to be false at that time, or were recklessly disregarded as such, for the reasons  
 7 stated herein in ¶ 64.

8 April 29, 2002 Press Release and Conference Call

9 75. On April 29, 2002, Terayon published a release announcing results for the first  
 10 quarter ended March 31, 2002. This release provided financial information about the Company, in  
 11 part, as follows:

12 *Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading supplier of*  
 13 *broadband access systems, today reported revenues of \$57.2 million for the first*  
 14 *quarter 2002, an increase of 6% from \$54.0 million for the first quarter 2001. The*  
 15 *pro forma net loss for the first quarter 2002 was \$3.9 million or \$0.05 per share,*  
 16 *compared to a pro forma net loss of \$29.3 million or \$0.43 per share for the same*  
 17 *period in 2001.*

18 \* \* \*

19 The GAAP net loss for the first quarter 2002 was \$4.1 million or \$0.06 per share,  
 20 compared to \$508.2 million or \$7.53 per share for the same period in 2001. Gross  
 21 margin in the first quarter of 2002 was 45%. *Excluding the benefit of reversing*  
 22 *\$11.4 million in inventory reserves and vendor cancellation charges, the gross*  
 23 *margin was 25%.* [Emphasis added.]

24 76. The Company's April 29, 2002 release also quoted defendant Zaki Rakib, in part, as  
 25 follows:

26 *"Given the current economic environment, we are pleased with these results.*  
 27 *However, revenues for the telecom business were significantly below our*  
 28 *expectations due to continued weakness in telecom capital spending. In addition,*  
 29 *revenues for the cable business were lower than expected due to the inability to ship*  
 30 *all of the cable modems on order for shipment during the quarter. The combination*  
 31 *of these factors resulted in lower total revenues than expected for the quarter," said*  
 32 *Terayon's CEO Dr. Zaki Rakib. "Despite these challenges, we were pleased with the*  
 33 *progress we made this quarter in DOCSIS CMTS sales, which accounted for*  
 34 *approximately \$8 million in revenues."* [Emphasis added.]

35 77. Later the same day, on April 29, 2002, defendants also conducted a conference call  
 36 for analysts and investors, hosted by defendants Lustenader and Zaki Rakib. During this call,  
 37 defendants reiterated the same or substantially similar material false and misleading statements  
 38

1 concerning Terayon's revenues, earnings, gross margins and projected growth, as had been made  
2 previously and contained in the Company's press release and its prior SEC filings. These  
3 statements were false and misleading and failed to disclose that defendants had purposely failed to  
4 report the Company's financial results in conformity with GAAP and SEC rules. These statements  
5 were also false and misleading for the reasons set forth at ¶ 64.

6 Form 10-Q for First Quarter of 2002

7 78. On or about May 15, 2002, defendants filed with the SEC the Company's Form 10-Q  
8 for the quarter ended March 31, 2002 ("1Q:02 Form 10-Q"), signed by defendant Lustenader. In  
9 addition to making substantially similar statements concerning the Company's finances and  
10 operations as had been made in the April 29, 2002 press release and conference call, the 1Q:02  
11 Form 10-Q also stated, in part, the following:

12 *The accompanying consolidated financial statements have been prepared in*  
13 *accordance with generally accepted accounting principles in the United States for*  
14 *interim financial information and in accordance with the instructions to Form 10-*  
15 *Q and Article 10 of Regulation S-X.... In the opinion of management, all*  
*adjustments (consisting of normal recurring adjustments) necessary for a fair*  
*presentation of the financial statements at March 31, 2002 and for the three*  
*months ended March 31, 2002 and 2001 have been included.* [Emphasis added.]

16 79. The Company's 1Q:02 Form 10-Q also contained additional statements regarding  
17 Terayon's critical accounting policies – including its revenue recognition policies – in part, as  
18 follows:

19 **Revenue Recognition**

20 The Company sells its products directly to broadband access service providers,  
21 system resellers and distributors and recognizes revenue upon shipment to the  
22 customer when title is transferred. *Revenues related to product sales are generally*  
23 *recognized when: (1) persuasive evidence that an arrangement exists, (2) delivery*  
*has occurred or services have been rendered, (3) the seller's price to the buyer is*  
*fixed or determinable, and (4) collectibility is reasonably assured. The Company's*  
24 *existing agreements with its system resellers and distributors do not contain price*  
*protection provisions and do not grant return rights beyond those provided by the*  
*Company's standard warranty.* [Emphasis added.]

25 80. The statements made by defendants and contained in the Company's April 29, 2002  
26 press release, those statements made by defendants during the quarterly conference call, and those  
27 statements contained in Terayon's 1Q:02 Form 10-Q, were each materially false and misleading and  
28

1 were know by defendants to be false at that time, or were recklessly disregarded as such, for the  
2 reasons stated herein in ¶ 64.

3 July 29, 2002 Press Release and Conference Call

4 81. On July 29, 2002, Terayon published a release announcing results for the second  
5 quarter ended June 30, 2002. This release provided financial and operational information about the  
6 Company, in part, as follows:

7 ***Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading supplier of***  
8 ***broadband solutions, today reported revenues of \$22.4 million for the second***  
9 ***quarter 2002, a decrease of 66% from \$65.7 million for the second quarter 2001.***  
10 ***For the six months ended June 30, 2002, revenues were \$79.6 million, a decrease of***  
11 ***33% from \$119.7 million for the same period 2001. The pro forma net loss for the***  
12 ***second quarter 2002 was \$28.3 million or \$0.39 per share, compared to a pro***  
13 ***forma net loss of \$54.5 million or \$0.81 per share for the same period 2001. The***  
14 ***pro forma net loss for the six months ended June 30, 2002 was \$32.2 million or***  
15 ***\$0.44 per share, compared to a pro forma net loss of \$83.8 million or \$1.24 for the***  
16 ***same period 2001.***

17 \* \* \*

18 In the second quarter, the gain resulting from the retirement of debt was \$33.3  
19 million, and the write down of investments totaled \$4.5 million. In addition, in the  
20 second quarter 2002, Terayon recorded a \$4.0 million charge related to the  
21 impairment of goodwill and other intangible assets. ***The GAAP net loss for the***  
22 ***second quarter 2002 was \$3.7 million or \$0.05 per share, compared to \$62.5***  
23 ***million or \$0.93 per share for the same period 2001.***

24 ***The GAAP net loss for the six months ended June 30, 2002 was \$7.8 million or***  
25 ***\$0.11 per share, compared to \$570.7 million or \$8.45 per share for the same period***  
26 ***2001. [Emphasis added.]***

27 82. The Company's July 29, 2002 release again quoted defendant Zaki Rakib, in part, as  
28 follows:

29 Terayon's CEO Zaki Rakib said, ***"Our revenues reflect the challenge of***  
30 ***transitioning from proprietary to standards-based products during a period of***  
31 ***difficult market conditions. While disappointed by the short-term outlook, we are***  
32 ***encouraged by the growing demand for DOCSIS 2.0-based products.*** In the  
33 previous quarter and during this quarter we have and will be fulfilling orders for our  
34 DOCSIS 2.0-based modems from three of the top four U.S. MSOs. The early  
35 adoption of DOCSIS 2.0 benefits Terayon given our leadership in its  
36 implementation." [Emphasis added.]

37 83. The Company's July 29, 2001 release also noted:

38 ***Terayon expects revenues in the third quarter to be in the range of \$15 to \$25***  
39 ***million and the pro forma net loss to be in the range of \$0.35 to \$0.39 per share.***



1 *For the full year, Terayon expects revenues, excluding Imedia Semiconductor, to*  
 2 *be in the range of \$110 to \$130 million, and the pro forma per share loss to be in*  
 3 *the range of \$1.15 to \$1.41 per share. Terayon plans to fund Imedia at a cost of*  
 4 *approximately \$5 to \$6 million per quarter.*

5 *Through aligning company resources to its strategic areas and to market*  
 6 *conditions, Terayon will be able to achieve a reduction in its operating expenses in*  
 7 *the near term. With the exclusion of Imedia Semiconductor, Terayon expects*  
 8 *operating expenses to be below \$20 million in the first quarter, 2003. [Emphasis*  
 9 *added.]*

10 84. Later the same day, on July 29, 2002, defendants also conducted a conference call for  
 11 analysts and investors, hosted by defendants Lustenader and Zaki Rakib. During this call,  
 12 defendants reiterated the same or substantially similar material false and misleading statements  
 13 concerning Terayon's revenues, earnings, and gross margins, as had been made previously and  
 14 contained in the Company's press releases and SEC filings. These statements too were false and  
 15 misleading for the reasons set forth at ¶ 64.

16 *Form 10-Q for Second Quarter of 2002*

17 85. On or about July 29, 2002, defendants filed with the SEC the Company's Form 10-Q  
 18 for the quarter ended June 30, 2002 ("2Q:02 Form 10-Q"), signed by defendant Lustenader. In  
 19 addition to making substantially similar statements concerning the Company's operations as were  
 20 contained in Terayon's July 29, 2002 release, the 2Q:02 Form 10-Q also stated, in part, the  
 21 following:

22 *The accompanying condensed consolidated financial statements have been*  
 23 *prepared in accordance with generally accepted accounting principles in the*  
 24 *United States for interim financial information and in accordance with the*  
 25 *instructions to Form 10-Q and Article 10 of Regulation S-X.... In the opinion of*  
 26 *management, all adjustments (consisting of normal recurring adjustments)*  
 27 *necessary for a fair presentation of the financial statements at June 30, 2002 and*  
 28 *for the three and six months ended June 30, 2002 and 2001 have been included.*  
 [Emphasis added.]

86. The 2Q:02 Form 10-Q reported the Company's critical accounting policies –  
 including its revenue recognition policies – in part, as follows:

**Revenue Recognition**

The Company sells its products directly to broadband access service providers,  
 system resellers and distributors and recognizes revenue upon shipment to the  
 customer when title is transferred. *Revenues related to product sales are generally*

1 *recognized when: (1) persuasive evidence that an arrangement exists, (2) delivery*  
2 *has occurred or services have been rendered, (3) the seller's price to the buyer is*  
3 *fixed or determinable, and (4) collectibility is reasonably assured. The Company's*  
4 *existing agreements with its system resellers and distributors do not contain price*  
*protection provisions and do not grant return rights beyond those provided by the*  
*Company's standard warranty. [Emphasis added.]*

5 87. Regarding the Company's 5% Convertible Subordinated Notes, the 2Q:02 Form 10-  
6 Q stated, in part, the following:

7 **Convertible Subordinated Notes**

8 *In the first six months of 2001, the Company repurchased approximately \$195.6*  
9 *million of its Convertible Subordinated Notes (Notes) for \$68.5 million in cash,*  
10 *resulting in a gain of approximately \$121.5 million, net of related unamortized*  
11 *issuance costs of \$5.6 million. In April 2002, the Company adopted SFAS No. 145*  
12 *and determined that the extinguishment of its debt did not meet the criteria of an*  
13 *extraordinary item as set forth in SFAS No. 145. Accordingly, the Company will*  
14 *now report its gain from retirement of its Notes in its results of operations. All prior*  
15 *periods will reflect the adoption of SFAS No. 145. In the first six months of 2002,*  
16 *the Company repurchased approximately \$74 million of its Notes for \$39.2 million*  
17 *in cash, resulting in a gain included in operations of approximately \$33.3 million*  
18 *net of related unamortized issuance costs of \$1.5 million. [Emphasis added.]*

19 88. The statements made by defendants and contained in the Company's July 29, 2002  
20 press release, those statements made by defendants during the quarterly conference call, and those  
21 statements contained in Terayon's 2Q:02 Form 10-Q, were each materially false and misleading and  
22 were known by defendants to be false at that time, or were recklessly disregarded as such, for the  
23 reasons stated herein in ¶ 64.

24 October 28, 2002 Press Release and Conference Call

25 89. On October 28, 2002, Terayon published a release announcing results for the third  
26 quarter ended September 30, 2002. This release provided financial and operational information  
27 about the Company, in part, as follows:

28 *Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading supplier of*  
*broadband solutions, today reported revenues of \$24.5 million for the third quarter*  
*2002, a decrease of 69% from \$79.6 million for the third quarter 2001. For the nine*  
*months ended September 30, 2002, revenues were \$104.1 million, a decrease of 48%*  
*from \$199.3 million for the same period 2001.*

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///

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\* \* \*

In the third quarter of 2002, Terayon retired \$35.1 million of debt, resulting in a gain of \$15.8 million.

*The GAAP net loss for the third quarter 2002 was \$16.0 million or \$0.22 per share, compared to net income of \$13.1 million or \$0.19 per share for the same period 2001. The GAAP net loss for the nine months ended September 30, 2002 was \$23.7 million or \$0.33 per share, compared to a net loss of \$557.6 million or \$8.23 per share for the same period 2001. [Emphasis added.]*

90. The Company's October 28, 2002 release again quoted defendant Zaki Rakib, in part, as follows:

*"We're encouraged by the progress we made during the third quarter in transitioning from a leading manufacturer of proprietary cable broadband solutions to a leader in standards-based offerings," said Zaki Rakib, Terayon's CEO. "During the quarter, we made significant progress with the top U.S. MSOs. Four of the top six are currently deploying our DOCSIS 2.0 based TJ 615 and TJ 715 cable modems. Though the telecommunications industry remains challenging, we believe that the growing deployments of our DOCSIS 2.0-based modems, combined with our expanded relationships with the top MSOs, should present opportunities for our DOCSIS 2.0-based CMTS." [Emphasis added.]*

91. Later the same day, on October 28, 2002, defendants also conducted a conference call for analysts and investors, hosted by defendants Lustenader and Zaki Rakib. During this call, defendants reiterated the same or substantially similar material false and misleading statements concerning Terayon's revenues, earnings, and gross margins, as had been made previously and contained in the Company's press releases and SEC filings. These statements too were false and misleading and failed to disclose that defendants had not reported the Company's financial results in conformity with GAAP and SEC rules.

Form 10-Q for Third Quarter 2002

92. On or about November 15, 2002, defendants filed with the SEC the Company's Form 10-Q for the quarter ended September 30, 2002 ("3Q:02 Form 10-Q"), signed by defendant Lustenader. In addition to making substantially similar statements concerning the Company's operations as were contained in Terayon's October 28, 2002 release, the 3Q:02 Form 10-Q also stated, in part, the following:

*The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information .... In the opinion of management,*

1 *all adjustments (consisting of normal recurring adjustments) necessary for a fair*  
2 *presentation of the financial statements at September 30, 2002 and for the three*  
3 *and nine months ended September 30, 2002 and 2001 have been included.*  
[Emphasis added.]

4 93. The 3Q:02 Form 10-Q also reported the Company's critical accounting policies –  
5 including its revenue recognition policies – in part, as follows:

6 **Revenues.** We sell our products directly to broadband service providers, and to a  
7 lesser extent, resellers and integrators. *Revenues related to product sales are*  
8 *generally recognized when: (1) persuasive evidence that an arrangement exists, (2)*  
9 *delivery has occurred or services rendered, (3) the selling price is fixed or*  
10 *determinable, and (4) collectibility is reasonably assured. A provision is made for*  
11 *estimated product returns as product shipments are made. Our existing*  
12 *agreements typically do not grant return rights beyond those provided by the*  
13 *warranty.* [Emphasis added.]

14 94. Regarding the Company's 5% Convertible Subordinated Notes, the 3Q:02 Form 10-  
15 Q also stated, in part, the following:

16 **Convertible Subordinated Notes**

17 *In the three and nine months ended September 30, 2001, the Company*  
18 *repurchased approximately \$104.3 million and \$299.9 million, respectively, of*  
19 *Convertible Subordinated Notes (Notes) for \$45.0 million and \$113.4 million,*  
20 *respectively, in cash, resulting in a gain of approximately \$51.8 million and \$173.3*  
21 *million, respectively, net of related unamortized issuance costs and accrued taxes of*  
22 *\$7.5 million and \$13.2 million, respectively. In April 2002, the Company adopted*  
23 *SFAS No. 145 and determined that the extinguishment of its debt did not meet the*  
24 *criteria of an extraordinary item as set forth in SFAS No. 145. Accordingly, the*  
25 *Company is now reporting its gain from retirement of its Notes in its results of*  
26 *operations. All prior periods reflect the adoption of SFAS No. 145.*

27 *In the first three and nine months of 2002, the Company repurchased*  
28 *approximately \$35.1 million and \$109.1 million, respectively, of Notes for \$18.4*  
29 *million and \$57.6 million, respectively, in cash, resulting in a gain included in*  
30 *operations of approximately \$15.8 million and \$49.1 million, respectively, net of*  
31 *related unamortized issuance costs of \$0.9 million and \$2.4 million, respectively.*  
[Emphasis added.]

32 95. The 3Q:02 Form 10-Q also contained statements that attested to the purported  
33 adequacy of the Company's controls and procedures, in part, as follows:

34 *Within the 90 days prior to the date of filing this Quarterly Report on Form 10-Q, we*  
35 *carried out an evaluation, under the supervision and with the participation of*  
36 *management, including the Chief Executive Officer and the Chief Financial*  
37 *Officer, of the effectiveness of the design and operation of our disclosure controls*  
38 *and procedures pursuant to Exchange Act Rule 13a-14. Based upon that*  
39 *evaluation, the Chief Executive Officer and the Chief Financial Officer concluded*  
40 *that our disclosure controls and procedures are effective in timely alerting them to*

1 *material information relating to us (including its consolidated subsidiaries) which*  
2 *is required to be included in our periodic SEC filings..* [Emphasis added.]

3 Certifications of Form 10-Q for Third Quarter of 2002

4 96. The 3Q:02 Form 10-Q also contained Certifications by defendants Lustenader and  
5 Zaki Rakib that certified, in part, as follows:

6 *Based on my knowledge, this quarterly report does not contain any untrue*  
7 *statement of a material fact or omit to state a material fact necessary to make the*  
8 *statements made, in light of the circumstances under which such statements were*  
9 *made, not misleading with respect to the period covered by this quarterly report;*

10 *Based on my knowledge, the financial statements, and other financial information*  
11 *included in this quarterly report, fairly present in all material respects the*  
12 *financial condition, results of operations and cash flows of the registrant as of,*  
13 *and for, the periods presented in this quarterly report;*

14 \* \* \*

15 [The registrant's other certifying officers and I] *evaluated the effectiveness of the*  
16 *registrant's disclosure controls and procedures as of a date within 90 days prior to*  
17 *the filing date of this quarterly report (11/14/02); and... presented in this quarterly*  
18 *report our conclusions about the effectiveness of the disclosure controls and*  
19 *procedures based on our evaluation as of the Evaluation Date;*

20 \* \* \*

21 [The registrant's other certifying officers and I have disclosed] *all significant*  
22 *deficiencies in the design or operation of internal controls which could adversely*  
23 *affect the registrant's ability to record, process, summarize and report financial*  
24 *data and have identified for the registrant's auditors any material weaknesses in*  
25 *internal controls; and b) any fraud, whether or not material, that involves*  
26 *management or other employees who have a significant role in the registrant's*  
27 *internal controls...*

28 97. In connection with the 3Q:02 Form 10-Q, defendants Lustenader and Zaki Rakib also  
provided certifications pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the  
Sarbanes-Oxley Act of 2002 ("SOX") that *"the information contained in the Report fairly*  
*presents, in all material respects, the financial condition and results of operations of the*  
*Company."* [Emphasis added].

98. The statements made by defendants and contained in the Company's October 28,  
2002 press release, those statements made by defendants during the quarterly conference call, and  
those statements contained in Terayon's 3Q:02 Form 10-Q, were each materially false and



misleading and were know by defendants to be false at that time, or were recklessly disregarded as such, for the reasons stated herein in ¶ 64.

January 30, 2003 Release

99. On January 30, 2003, Terayon published a release announcing results for the fourth quarter and full year ended December 31, 2002. This release stated, in part, the following:

*Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading supplier of broadband solutions, today reported revenues of \$25.3 million for the fourth quarter 2002, a decrease of 68% from \$80.2 million for the same period 2001. For the 12 months ended December 31, 2002, revenues were \$129.4 million, a decrease of 54% from \$279.5 million for the same period 2001.*

*The net loss for the fourth quarter 2002 was \$20.5 million or \$0.28 per share, compared to a net loss of \$6.2 million or \$0.09 per share for the same period 2001. The net loss for the 12 months ended December 31, 2002 was \$44.2 million or \$0.61 per share, compared to a net loss of \$563.8 million, or \$8.25 per share for the same period 2001.*

\* \* \*

*During the fourth quarter of 2002, Terayon made additional progress in aligning the company's operating expenses with current market conditions. Operating expenses for the fourth quarter 2002 were \$18.9 million, excluding Imedia Semiconductor. This is ahead of the company's stated goal of reducing expenses below \$20 million, excluding Imedia Semiconductor, in the first quarter of 2003. [Emphasis added.]*

100. The Company's January 30, 2003 release also quoted defendant Zaki Rakib, in part, as follows:

Commenting on Terayon's accomplishments during the year, Terayon's CEO, Zaki Rakib said, *"We met many of our key strategic goals during 2002,* including: (1) achieving DOCSIS™ 2.0 certification and qualification for our cable modems and CMTS; (2) increasing sales of data products to the top U.S. MSOs, as evidenced by sales to divisions of Adelphia, Comcast, Cox and Time Warner Cable; (3) ramping up volume production of our DOCSIS 2.0 products; (4) cost-reducing our products, in particular our cable modems; (5) maintaining our leadership position in digital video with our CherryPicker; (6) strengthening Imedia Semiconductor's position as a broadband silicon provider; and (7) *maintaining a strong balance sheet: during 2002,* despite a challenging economy and significant investments in research and development, our net cash position (cash and equivalents minus the face value of convertible debt) decreased by \$18.3 million. Our ending cash and equivalents on hand is \$206.5 million and the face value of convertible debt is \$65.1 million." [Emphasis added.]

101. Later the same day, on January 30, 2003, defendants also conducted a conference call for analysts and investors, hosted by defendants Lustenader and Zaki Rakib. During this call,

1 defendants reiterated the same or substantially similar material false and misleading statements  
 2 concerning Terayon's revenues, earnings, and gross margins, as had been made previously and  
 3 contained in the Company's press releases and SEC filings. These statements were false and  
 4 misleading for the reasons set forth at ¶ 64.

5 *Abrupt Resignation of Defendant Lustenader*

6 102. On February 26, 2003, defendants announced that Lustenader had resigned as Chief  
 7 Financial Officer of the Company, and was being replaced by Arthur T. Taylor. At the time of her  
 8 resignation, defendants led the market to believe that there was no disagreement over the  
 9 Company's financial reporting, and that defendant Lustenader had left Terayon "to pursue other  
 10 interests."

11 *Restructuring in 2003: Plant Closings and Layoffs*

12 103. On March 14, 2003, defendants published a release announcing that the Company  
 13 was undergoing a complete restructuring designed to rationalize products and staff and reduce costs.  
 14 At that time, defendants published a release that quoted defendant Zaki Rakib and that stated, in  
 15 part, the following:

16 Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading supplier of  
 17 broadband solutions, today announced a *worldwide restructuring designed to reduce*  
 18 *its operating costs, improve efficiencies and re-align resources to focus on its core*  
 19 *product offerings for the world's leading cable operators. Measures implemented*  
 20 *include a reduction in force of approximately 100 employees, or 20 percent of the*  
 21 *workforce, and the closure of certain remote facilities. Terayon anticipates*  
 22 *realizing approximately \$12 million to \$15 million in annualized savings from*  
 23 *these actions, combined with related operational savings including curtailment of*  
 24 *certain program and discretionary expenses. The company expects to record total*  
 25 *charges in the range of approximately \$4 million to \$5 million associated with the*  
 26 *realignment and the writedown of certain related assets in the quarter ending*  
 27 *March 31, 2003.*

28 *"We are committed to achieving profitability and are taking the necessary steps to*  
 29 *facilitate reaching this key milestone," said Zaki Rakib, Terayon's CEO. "We have*  
 30 *identified areas of our operations to streamline and consolidate, while retaining the*  
 31 *key resources to deliver upon the commitments we have made to our customers and*  
 32 *to continue investing strategically for the future. We are encouraged by the strong*  
 33 *interest customers are showing in Terayon's data, video and voice product lines*  
 34 *and are looking to generate positive momentum in the coming quarters."*  
 35 [Emphasis added.]

2002 Form 10-K

104. On or about March 27, 2003, defendants filed with the SEC the Company's 2002 Form 10-K for the year ended December 31, 2002, signed by defendants Zaki Rakib, Taylor, Shlomo Rakib, Schaepe, Solomon and Woodrow. In addition to making substantially similar statements concerning the Company's operations as were contained in the Company's January 30, 2003 and March 14, 2003 releases, the 2002 Form 10-K also described Terayon's Critical Accounting Policies, in part, as follows:

**Critical Accounting Policies**

We consider certain accounting policies related to revenue recognition, bad debt reserves, inventory valuation, impairment of long-lived assets, warranty returns, restructuring, accounting for share based compensation and contingencies to be critical policies due to the estimation processes involved in each. *We discuss each of our critical accounting policies, in addition to certain less significant accounting policies, with senior members of management and the audit committee, as appropriate.*

**Use of Estimates.** The preparation of the consolidated financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires us to establish accounting policies that contain estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. *On an on-going basis, we evaluate our estimates, including those related to product returns, bad debts, inventories, investments, intangible assets and contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources.* These policies include:

- *revenue recognition;*
- *the allowance for doubtful accounts, which impacts revenue;*
- *the valuation of exposures associated with the contract manufacturing operations and estimating future warranty costs, which impact cost of goods sold and gross margins;*
- *and*
- *the valuation of certain long-lived assets, especially goodwill and other purchased intangible assets, which has resulted in impairment, which impacts operating expenses.*



We have other equally important accounting policies and practices which may not require us to make significant estimates or assumptions. Despite our intention to establish accurate estimates and assumptions, actual results could differ from those estimates under different assumptions or conditions.

**Revenue Recognition.** We recognize revenue in accordance with SEC Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB 101), as amended by *SAB 101A and 101B. SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (4) is based on management's judgments regarding the collectibility of the selling price.* Should there be changes to management's judgments, revenue recognized for any reporting period could be adversely affected. [Emphasis added.]

105. Regarding the Company's 5% Convertible Subordinated Notes, the 2002 Form 10-K stated, in part, the following:

#### Convertible Subordinated Notes

*In July 2000, the Company issued \$500 million of 5% Convertible Subordinated Notes due in August 2007 (Convertible Notes) resulting in net proceeds to the Company of approximately \$484.4 million.* The Convertible Notes are the Company's general unsecured obligation and are subordinated in right of payment to all existing and future senior indebtedness and to all of the liabilities of the Company's subsidiaries. The Convertible Notes are convertible into shares of the Company's common stock at a conversion price of \$84.01 per share at any time on or after October 24, 2000 through maturity, unless previously redeemed or repurchased. The Company may redeem some or all of the Convertible Notes at any time on or after October 24, 2000 and before August 7, 2003 at a redemption price of \$1,000 per \$1,000 principal amount of the Convertible Notes, plus accrued and unpaid interest, if any, if the closing price of the Company's stock exceeds 150% of the conversion price, or \$126.01 for at least 20 trading days within a period of 30 consecutive trading days ending on the trading day prior to the date of mailing of the redemption notice. The Company will also make an additional payment of \$193.55 per \$1,000 principal amount of Convertible Notes, less the amount of any interest actually paid on the Convertible Notes before the date of redemption. The Company may redeem the Convertible Notes at any time on or after August 7, 2003 at specified prices plus accrued and unpaid interest. Interest is payable semi-annually. *Debt issuance costs related to the Convertible Notes were approximately \$15.6 million and are amortized over seven years. At December 31, 2002 amortization of debt issuance costs totaled \$14.2 million.*

*In 2001, the Company repurchased approximately \$325.9 million of Convertible Notes for \$113.4 million in cash and \$17.9 million in stock, resulting in a gain of approximately \$185.3 million, net of related unamortized issuance costs of \$9.3 million. In 2002, the Company repurchased approximately \$109.1 million of Convertible Notes for \$57.6 million in cash, resulting in a gain of approximately \$49.1 million, net of related unamortized issuance costs of \$2.4 million.*

\* \* \*

Approximately \$65.1 million of Convertible Notes were outstanding at December 31, 2002. [Emphasis added.]

106. The Company's 2002 Form 10-K also reported Terayon's Liquidity and Capital Resources, in part, as follows:

At December 31, 2002, we had approximately \$117.1 million in cash and cash equivalents and \$89.4 million in short-term investments. *At December 31, 2001, we had approximately \$100.3 million in cash and cash equivalents and \$233.6 million in short-term investments.*

*In July 2000, we issued \$500 million of Notes, resulting in net proceeds to us of approximately \$484.4 million.* The Notes are our general unsecured obligation and are subordinated in right of payment to all of our existing and future senior indebtedness and to all of the liabilities of our subsidiaries. The Notes are convertible into shares of our common stock at a conversion price of \$84.01 per share at any time on or after October 24, 2000 through maturity, unless previously redeemed or repurchased. Interest is payable semi-annually. *Debt issuance costs related to the Notes were approximately \$15.6 million.*

*Through December 31, 2002, we had repurchased approximately \$434.9 million of the Notes for \$171.0 million in cash and \$17.9 million in stock, resulting in a gain on early retirement of debt of approximately \$234.4 million net of related unamortized issuance costs of \$11.6 million.* [Emphasis added.]

107. The Company's 2002 Form 10-K also contained statements that purported to attest to the adequacy of Terayon's controls and procedures, in part, as follows:

(a) Evaluation of disclosure controls and procedures. Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of the company's "disclosure controls and procedures" (as defined in the Securities Exchange Act of 1934 Rules 13a-14(c) and 15-d-14(c)) as of a date (Evaluation Date) within 90 days before the filing date of this annual report, have concluded that as of the Evaluation Date, *our disclosure controls and procedures were adequate and designed to ensure that material information relating to us and our consolidated subsidiaries would be made known to them by others within those entities.*

(b) Changes in internal controls. There were no significant changes in our internal controls or to our knowledge, in other factors that could significantly affect our disclosure controls and procedures subsequent to the Evaluation Date. [Emphasis added.]

108. The Company's 2002 Form 10-K also contained SOX Certifications signed by defendants Taylor and Zaki Rakib and filed with the SEC. These Certifications stated, in part that



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1 *"the information contained in the Report fairly presents, in all material respects, the financial*  
2 *condition and results of operations of the Company at the dates and for the periods indicated."*

3 *January 24, 2003 Ernst & Young Report*

4 109. For full year 2002, Ernst & Young charged the Company over \$610,000 for audit  
5 related fees. After completing that review at year end 2002, Ernst & Young provided its report,  
6 dated January 24, 2003, to the Board of Directors and Stockholders of the Company. The Report  
7 read in part as follows:

8 *We have audited the accompanying consolidated balance sheets of Terayon*  
9 *Communication Systems, Inc. as of December 31, 2002 and 2001, and the related*  
10 *consolidated statements of operations, stockholders' equity, and cash flows for*  
11 *each of the three years in the period ended December 31, 2002.... Our*  
12 *responsibility is to express an opinion on these financial statements and schedule*  
13 *based on our audits.*

14 *We conducted our audits in accordance with auditing standards generally accepted*  
15 *in the United States.... We believe that our audits provide a reasonable basis for*  
16 *our opinion.*

17 *In our opinion, the consolidated financial statements referred to above present*  
18 *fairly, in all material respects, the consolidated financial position of Terayon*  
19 *Communication Systems, Inc. at December 31, 2002 and 2001, and the*  
20 *consolidated results of its operations and its cash flows for each of the three years*  
21 *in the period ended December 31, 2002, in conformity with accounting principles*  
22 *generally accepted in the United States.*  
23 [Emphasis added.]

24 110. The statements made by defendants and contained in the Company's January 30,  
25 2003 press release, those statements made by defendants during the quarterly conference call, and  
26 those statements contained in Terayon's 2002 Form 10-K, were each materially false and misleading  
27 and were know by defendants to be false at that time, or were recklessly disregarded as such, for the  
28 reasons stated herein in ¶ 64.

29 *April 29, 2003 Press Release and Conference Call re: 1Q:03 Results*

30 111. On April 29, 2003, Terayon published a release announcing results for the quarter  
31 ended March 31, 2003. This release provided financial and operational information about the  
32 Company, in part, as follows:

1 **Terayon Reports First Quarter 2003 Financial Results**

2 *Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading supplier of*  
 3 *broadband solutions, today reported revenues of \$22.3 million for the first quarter*  
 4 *2003, a decrease of 61% from \$57.2 million for the first quarter 2002. The net loss*  
 5 *for the first quarter was \$24.0 million or \$0.33 per share, compared to a net loss of*  
*\$4.1 million or \$0.06 per share for the same period in 2002. These results include the*  
*impact of a restructuring charge of \$3.2 million, or \$0.04 per share, associated with*  
*the workforce reduction announced in March 2003.*

6 \* \* \*

7 *Terayon took several steps during the first quarter to accelerate its path to*  
 8 *profitability. These included a workforce reduction and further realignment of the*  
*company's operating expenses with current market conditions. [Emphasis added.]*

9 112. The Company's April 29, 2003 release also quoted defendant Zaki Rakib, in part, as  
 10 follows:

11 *"Identifying areas to streamline and further consolidation of operations to meet*  
 12 *our financial goals, while still investing strategically for the future, remain key*  
*objectives for Terayon in 2003," said Rakib.*

13 *"Despite difficult market conditions, we came within our previously announced*  
 14 *revenue target range for the first quarter," said Zaki Rakib, Terayon's CEO. "Like*  
 15 *other equipment providers serving the cable industry, Terayon is experiencing a*  
 16 *challenging and uncertain spending environment in 2003. However, we are*  
 17 *encouraged by the growing orders for our DOCSIS 2.0 (Data Over Cable Service*  
*Interface Specification) cable modems and that four of the top five U.S. cable*  
*operators are in various stages of testing or conducting field trials of our DOCSIS 2.0*  
*CMTS (Cable Modem Termination System)." [Emphasis added.]*

18 113. Later the same day, on April 29, 2003, defendants also conducted a conference call  
 19 for analysts and investors, hosted by defendants Lustenader and Zaki Rakib. During this call,  
 20 defendants reiterated the same or substantially similar material false and misleading statements  
 21 concerning Terayon's revenues, earnings, and gross margins as had been made previously and  
 22 contained in the Company's press releases and SEC filings. These statements were false and  
 23 misleading for the reasons set forth at ¶ 64.

24 *Form 10-Q for First Quarter 2003*

25 114. On or about May 15, 2003, defendants filed with the SEC the Company's Form 10-Q  
 26 for the quarter ended March 31, 2003 ("1Q:03 Form 10-Q"), signed by defendant Taylor. In  
 27 addition to making substantially similar statements concerning the Company's operations as had  
 28 been made by defendants previously, the 1Q:03 Form 10-Q also stated, in part, the following:

1 *The accompanying condensed consolidated financial statements have been*  
2 *prepared in accordance with generally accepted accounting principles in the*  
3 *United States for interim financial information and in accordance with the*  
4 *instructions to Form 10-Q and Article 10 of Regulation S-X. ... In the opinion of*  
5 *management, all adjustments (consisting of normal recurring adjustments)*  
6 *necessary for a fair presentation of the financial statements at March 31, 2003 and*  
7 *for the three months ended March 31, 2003 and 2002 have been included.*  
8 [Emphasis added.]

9 115. The Company's 1Q:03 Form 10-Q also reported Terayon's Liquidity and Capital  
10 Resources, in part, as follows:

11 At September 30, 2003, we had approximately \$42.4 million in cash and cash  
12 equivalents and \$107.0 million in short-term investments. *As of September 30, 2003,*  
13 *we had approximately \$68.4 million of long-term obligations, principally relating*  
14 *to our 5% Convertible Subordinated Notes.*

15 *In July 2000, we issued \$500 million of 5% Convertible Subordinated Notes, or*  
16 *Notes, due in August 2007, resulting in net proceeds to us of approximately \$484.4*  
17 *million. The Notes are our general unsecured obligation and are subordinated in*  
18 *right of payment to all of our existing and future senior indebtedness and to all of*  
19 *the liabilities of our subsidiaries. The Notes are convertible into shares of our*  
20 *common stock at a conversion price of \$84.01 per share at any time on or after*  
21 *October 24, 2000 through maturity, unless previously redeemed or repurchased.*  
22 *Interest is payable semi-annually. Debt issuance costs related to the Notes were*  
23 *approximately \$15.6 million.*

24 *Through September 30, 2003, we had repurchased approximately \$434.9 million*  
25 *of the Notes for \$171.0 million in cash and \$17.9 million in stock, resulting in a*  
26 *gain on early retirement of debt of approximately \$234.4 million net of related*  
27 *unamortized issuance costs of \$11.6 million. We did not repurchase any Notes*  
28 *during the first nine months of 2003. [Emphasis added.]*

116. The 1Q:03 Form 10-Q also contained statements that reported the adequacy and  
sufficiency of the Company's Controls and Procedures, in part, as follows:

Within the 90 days prior to the date of filing this Quarterly Report on Form 10-Q, we  
carried out an evaluation, under the supervision and with the participation of  
management, including the Chief Executive Officer and the Chief Financial Officer,  
of the effectiveness of the design and operation of our disclosure controls and  
procedures pursuant to Exchange Act Rule 13a-14. *Based upon that evaluation, the*  
24 *Chief Executive Officer and the Chief Financial Officer concluded that our*  
25 *disclosure controls and procedures are effective in timely alerting them to material*  
26 *information relating to us (including its consolidated subsidiaries) which is*  
27 *required to be included in our periodic SEC filings. Subsequent to the date of that*  
28 *evaluation, there have been no significant changes in our internal controls or in*  
*other factors that could significantly affect internal controls, nor were any*  
*corrective actions required with regard to significant deficiencies and material*  
*weaknesses. [Emphasis added.]*



SOX Certifications Regarding First Quarter 2003

117. The Company's 1Q:03 Form 10-Q also contained SOX Certifications signed by defendants Taylor and Zaki Rakib and filed with the SEC. These Certifications stated, in part, "*the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company at the dates and for the periods indicated.*" [Emphasis added.]

118. The statements made by defendants and contained in the Company's April 29, 2003 press release, those statements made by defendants during the quarterly conference call, and those statements contained in Terayon's 1Q:03 Form 10-Q, were each materially false and misleading and were known by defendants to be false at that time, or were recklessly disregarded as such, for the reasons stated herein in ¶ 64.

July 30, 2003 Press Release and Conference Call re: 2Q:03 Results

119. On July 30, 2003, Terayon published a release announcing results for the second quarter ended June 30, 2003. This release provided financial and operational information about the Company, in part, as follows:

**Terayon Reports Second Quarter 2003 Financial Results**

Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading provider of broadband solutions, *today announced financial results in line with its previously-raised guidance for the second quarter ended June 30, 2003.*

*Revenues for the second quarter of 2003 were \$30.6 million, an increase of 37% compared to \$22.4 million for the second quarter of 2002, and an increase of 37% from \$22.3 million for the first quarter of 2003.* Net loss for the second quarter of 2003 was \$13.1 million, or \$0.18 per share, compared to a net loss of \$3.7 million, or \$0.05 per share, for the second quarter of 2002, and a net loss of \$24.0 million, or \$0.33 per share, for the first quarter of 2003. [Emphasis added.]

120. The Company's July 30, 2003 release also quoted defendant Zaki Rakib, in part, as follows:

*"We are pleased with our progress this quarter and the continued positive momentum we are seeing with cable operator interest in our DOCSIS 2.0 solutions,"* said Zaki Rakib, Terayon's Chief Executive Officer. "In addition, we believe we are well positioned to capitalize on our DOCSIS 2.0 and digital video leadership positions as the cable industry works to meet the bandwidth management challenges presented by the expected growth of High Definition TV (HDTV), Video

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on Demand, and new IP based services required to compete against telecom and satellite offerings. *Going into the second half of 2003, we remain focused on achieving sustainable profitability through growing revenues, improving margins via product cost reductions, and prudent operating expense management.* [Emphasis added.]

121. Later the same day, on July 30, 2003, defendants also conducted a conference call for analysts and investors, hosted by defendants Taylor and Zaki Rakib. During this call, defendants reiterated the same or substantially similar material false and misleading statements concerning Terayon's revenues, earnings, and gross margins as had been made previously and contained in the Company's press release and prior SEC filings. In addition, during this call, defendant Rakib also stated, in part, the following:

ZAKI RAKIB, CEO, TERAYON COMMUNICATIONS SYSTEMS: Thanks Art. As you may have noted from our press release this afternoon, *our revenues and loss per share for Q2, we're in line with the ranges we pre-announced on July third, and were better than the guidance we provided on our last earnings call. We are pleased with our progress in the second quarter, and believe we are generating increased momentum going into the second half of this year....* [Emphasis added.]

122. Also, during the July 30, 2003 conference call, defendant Taylor also stated, in part, the following:

ARTHUR TAYLOR: Thank you Zaki. I would like to present the financial highlights for the second quarter an outline our revenue and loss per share expectations in the third quarter. *Looking at the second quarter P&L we reported \$30.6m in net revenues, which was within the range we provided in our press release of July 3rd. As we noted in our press release, revenues came in higher than the anticipated range of \$24m-\$28m we provided in our last earnings call due primarily to the following three reasons.*

\* \* \*

*Moving down the balance sheet, total current liabilities declined by \$1.7m to \$56.2m as of June 30th due in part to the reduction in the previously mentioned vendor cancellation charges.* As of June 30th the vendor cancellation liability on the balance sheet stood at \$6.5m. We ended the quarter with 404 employees compared to 406 employees as at March 31st. Over the next two quarters we anticipate this number will increase slightly to support the anticipated growth in CMTS deployment and in completion of important milestones on our product development roadmaps.

\* \* \*

*We are targeting revenues for Q3 to be in the range of \$33.0m to \$36.0m.* We have factored in the absence of the Telco Mini Flex revenue stream due to our sale of the product line early this month, as well substantially lower demand for our Legacy SCMA products. The net loss per share is anticipated to be in the range of 14 cents to

16 cents per share, based on 74.5m average shares outstanding. **We are targeting to end the quarter with approximately \$144m to \$147m in cash and equivalence and re anticipating no change in the amount of debt on our balance sheet.** [Emphasis added.]

Form 10-Q for Second Quarter 2003

123. On or about August 14, 2003, defendants filed with the SEC the Company's Form 10-Q for the quarter ended June 30, 2003 ("2Q:03 Form 10-Q"), signed by defendant Taylor and certified by defendants Taylor and Zaki Rakib. In addition to making substantially similar statements concerning the Company's operations as were contained in Terayon's July 30, 2003 release, the 2Q:03 Form 10-Q also reported the Company's critical accounting policies, in part, as follows:

*The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X.... In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial statements at June 30, 2003 and for the three and six months ended June 30, 2003 and 2002 have been included.* [Emphasis added.]

124. The Company's 2Q:03 Form 10-Q also reported Terayon's Liquidity and Capital Resources, in part, as follows:

At June 30, 2003, we had approximately \$68.5 million in cash and cash equivalents and \$93.4 million in short-term investments. **As of June 30, 2003, we had approximately \$69.0 million of long-term obligations.**

**In July 2000, we issued \$500 million of 5% Convertible Subordinated Notes (Notes) due in August 2007, resulting in net proceeds to us of approximately \$484.4 million.** The Notes are our general unsecured obligation and are subordinated in right of payment to all of our existing and future senior indebtedness and to all of the liabilities of our subsidiaries. The Notes are convertible into shares of our common stock at a conversion price of \$84.01 per share at any time on or after October 24, 2000 through maturity, unless previously redeemed or repurchased. Interest is payable semi-annually. **Debt issuance costs related to the Notes were approximately \$15.6 million.**

**Through June 30, 2003, we had repurchased approximately \$434.9 million of the Notes for \$171.0 million in cash and \$17.9 million in stock, resulting in a gain on early retirement of debt of approximately \$234.4 million net of related unamortized issuance costs of \$11.6 million.** We did not repurchase any Notes during the first six months of 2003. [Emphasis added.]



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1 125. The Company's 2Q:03 Form 10-Q also contained statements that purported to attest  
2 to the adequacy of Terayon's controls and procedures, in part, as follows:

3 As of the end of the period covered by report, we carried out an evaluation, under the  
4 supervision and with the participation of our Chief Executive Officer and Chief  
5 Financial Officer, of the effectiveness of the design and operation of our disclosure  
6 controls and procedures. *Based on this evaluation, our Chief Executive Officer and  
7 Chief Financial Officer concluded that our disclosure controls and procedures are  
8 effective in timely alerting them to material information this report.*

9 *There has been no change in our internal controls over financial reporting that  
10 occurred during our most recent fiscal quarter* that has materially affected or is  
11 reasonably likely to materially affect our internal controls over financial reporting.  
12 [Emphasis added.]

13 SOX Certifications Regarding Second Quarter 2003

14 126. The Company's 2Q:03 Form 10-Q also contained SOX Certifications signed by  
15 defendants Taylor and Zaki Rakib and filed with the SEC. These Certifications stated, in part, "*the*  
16 *information contained in the Report fairly presents, in all material respects, the financial*  
17 *condition and results of operations of the Company at the dates and for the periods indicated.*"  
18 [Emphasis added.]

19 127. The statements made by defendants and contained in the Company's July 30, 2003  
20 press release, those statements made by defendants during the quarterly conference call, and those  
21 statements contained in Terayon's 2Q:03 Form 10-Q, were each materially false and misleading and  
22 were known by defendants to be false at that time, or were recklessly disregarded as such, for the  
23 reasons stated herein in ¶ 64.

24 October 7, 2003 Announcement of Shelf Registration

25 128. Attempting to take further advantage of the artificial inflation in the price of Terayon  
26 stock caused by defendants' publication of materially false and misleading statements about the  
27 Company, on October 7, 2003, defendants announced that Terayon would file with the SEC a Shelf  
28 Registration Statement in connection with the planned sale of at least \$125 million in Company  
securities. This shelf registration would allow the Company, from time to time, to sell Terayon  
stock on an expedited basis.

October 7, 2004 Revenue Update Regarding 3Q:03

129. Also, on October 7, 2003, defendants announced purported consensus beating financial results for 3Q:03. This release stated, in part, the following;

***Terayon Provides Update on Better Than Expected Third Quarter Financial Performance***

***Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading provider of broadband solutions, today announced it expects revenues for its third quarter ending September 30, 2003 to be in the range of \$37 million to \$38 million. Net loss per share for the quarter is now expected to be in the range of \$0.10 to \$0.12.*** Included in the expected net loss per share is approximately \$0.02 of non-recurring gain resulting from the reversal of a liability from a previously acquired company, and the Company's previously announced sale of its telco Miniplex product line and related inventory.

***This revised guidance compares favorably with previously provided estimates by the Company that revenues for the third quarter would be in the range of \$33 million to \$36 million, and that the net loss per share would be in the range of \$0.14 to \$0.16, including an expected \$0.01 non-recurring gain from the Miniplex transaction.***

***In its second quarter ending June 30, 2003, Terayon reported net revenues of \$30.6 million and a net loss per share of \$0.18.***

***"Our better than expected revenue performance for the third quarter stems primarily from higher unit shipments of our DOCSIS 2.0 CMTS (Cable Modem Termination System), stronger sales of our video headend product line, and higher than anticipated sales of our legacy S-CDMA products, partially offset by somewhat lower than expected DOCSIS 2.0 modem sales,"*** said Zaki Rakib, Terayon's CEO. ***"We are particularly pleased with the growing customer acknowledgement of the economic and performance advantages of our DOCSIS 2.0 BW CMTS, as evidenced by the revenue growth we have seen over the last three quarters. Our better than anticipated net loss performance for the quarter is attributable to higher sales, a favorable product mix resulting in higher gross margin, and lower operating expenses due to continued cost containment efforts."*** [Emphasis added.]

October 22, 2003 Press Release and Conference Call re: Results for 3Q:03

130. On October 22, 2003, Terayon published a release announcing results for the third quarter ended September 30, 2003. This release provided financial information about the Company, in part, as follows:

***Terayon Reports Third Quarter 2003 Financial Results***

Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading innovator of intelligent broadband access, ***today announced financial results in line with its previously-raised guidance for the third quarter ended September 30, 2003.***



1 *Revenues for the third quarter of 2003 were \$37.6 million, an increase of 54%*  
 2 *compared to \$24.5 million for the third quarter of 2002, and an increase of 23%*  
 3 *from \$30.6 million for the second quarter of 2003. Net loss for the third quarter of*  
 4 *2003 was \$7.2 million, or \$0.10 per share, which compares to a net loss of \$16.0*  
 5 *million, or \$0.22 per share, for the third quarter of 2002 and a net loss of \$13.1*  
 6 *million, or \$0.18 per share, for the second quarter of 2003.*

7 \* \* \*

8 *Included in non-operating income for the third quarter of 2003 is a non-recurring*  
 9 *gain of approximately \$1.3 million, or \$0.02 per share, due to the sale of the*  
 10 *Company's telco Miniplex product line and the reversal of a liability related to an*  
 11 *overseas government R&D grant. [Emphasis added.]*

12 131. The Company's October 22, 2003 release also quoted defendant Zaki Rakib, in part,  
 13 as follows:

14 *"We are pleased with our performance this quarter, as cable operators continue to*  
 15 *validate the economic and performance advantages of our DOCSIS 2.0 and digital*  
 16 *video solutions in the face of increasing competition from telecom and satellite*  
 17 *offerings," said Zaki Rakib, Terayon's Chief Executive Officer. "The growing need*  
 18 *for cable operators to offer competitive services such as high-speed data access, High*  
 19 *Definition TV (HDTV), and Video on Demand creates bandwidth management*  
 20 *challenges that they are addressing using Terayon solutions such as the DOCSIS 2.0*  
 21 *BW CMTS, DOCSIS 2.0 cable modems, and the DM 6400 Network CherryPicker.*  
 22 *We are encouraged by an improving trend in cable operator capital spending and*  
 23 *believe that we are well positioned for revenue growth in the fourth quarter due to*  
 24 *our industry leading solutions and our continued focus on operational execution."*  
 25 *[Emphasis added.]*

26 132. Later the same day, on October 22, 2003, defendants also conducted a conference  
 27 call for analysts and investors, hosted by defendants Taylor and Zaki Rakib. During this call,  
 28 defendants reiterated the same or substantially similar material false and misleading statements  
 concerning Terayon's revenues, earnings, and gross margins as had been made previously and  
 contained in the Company's press releases and SEC filings. In addition, during this call, defendant  
 Rakib also stated, in part, the following:

29 *I am pleased to report that our revenues and loss per share were better than the*  
 30 *guidance we provided during our last earnings call, and we are in line with the*  
 31 *ranges we pre-announced at October 7. Versus Q2 we grew revenues 23%*  
 32 *sequentially, increased our gross margins, reduced our operating expenses, and*  
 33 *continued to manage the balance sheet closely. I am pleased with our overall*  
 34 *execution and the progress we are making towards achieving profitability. We are*  
 35 *seeing improved capital spending by key cable operators for CMTS equipment and*  
 36 *digital video management systems, due in part to increase competition from Telco*  
 37 *and satellite companies. This competition is accelerating the roll out of new cable-*

1 based services, including video-on-demand, high-definition TV, voice-over IP, and  
 2 higher rates for high speed data subscribers. Since these new offerings require both  
 3 more bandwidth and bandwidth management, many cable operators are looking to  
 4 vendors such as Terayon to provide the solutions to help them grow revenue, reduce  
 subscriber churn, and lower their total cost of ownership. *We believe we are very  
 well positioned to assist cable operators successfully addressing these critical  
 objectives due to DOCSIS 2.0 and digital video leadership position.*

5 \* \* \*

6 *Looking forward, we are very encouraged by the improved market conditions and  
 7 the favorable industry dynamics going into the fourth quarter.* We believe the  
 8 cable operators will increasingly compete against the telecom and satellite companies  
 9 with more service offerings and increased throughput, which we think bodes very  
 10 well for both DOCSIS 2.0 and digital video management system adoption rates into  
 2004. We also believe we strengthened our ability to capitalize on the increasing  
 11 numbers of opportunities through the investments made in people, processes, and  
 12 systems over the past three quarters. *We believe that our value proposition is  
 resonating with our customers and our ability to deliver upon those promises  
 continues to improve. We feel we are well positioned to meet the growing needs of  
 our customers and to have that reflected in improving financial performance in  
 the quarters ahead.* [Emphasis added.]

13 133. During the October 22, 2003 conference call, defendant Taylor stated, in part, the  
 14 following:

15 **ARTHUR TAYLOR:** Thank you Zaki. I would like to present the financial  
 16 highlights for the third quarter and outline our revenue and loss per share  
 17 expectations for the fourth quarter. *Looking at the third quarter P&L, we reported  
 \$37.6m in net revenues, which was within the range we provided in our press  
 18 release of October 7. As we noted in our press release, revenues came in higher  
 than the anticipated range of \$33-36m we reported in our last earnings call due  
 primarily to the following three reasons.* First, our DOCSIS CMTS business was  
 19 stronger than expected due to increased demand in Japan and North America as Zaki  
 outlined earlier. Second, sales of our digital video head-end product line were higher  
 20 than expected due to increased demand coming largely from both escalating MSO  
 rollout of HDTV offerings, VOD, and digital ad insertion, coupled with our own  
 21 overall improved sales execution. The third reason our revenues exceeded our  
 original target was higher than anticipated sales from our legacy S-CDMA product  
 22 lines. Total S-CDMA revenues were approximately \$1.3m, which was much higher  
 23 than expected. As we have aligned the Company's focus and resources behind  
 extending our DOCSIS 2.0 leadership division, we expect sales of proprietary  
 24 products to be minimal going forward. Partially offsetting the higher than expected  
 performance was lower, DOCSIS 2.0 modem revenues due in part to lower than  
 25 expected unit sales overseas combined with the slower than expected ramp in unit  
 orders from certain U.S. based MSO's. We believe this latter issue is now resolving  
 26 itself and we are anticipating stronger cable modem revenue growth in Q4.  
 27 [Emphasis added.]  
 28

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November 6, 2003 Release Regarding Defendants' Intention  
to Sell Shares in Registered Offering

134. Attempting to take further advantage of the artificial inflation in the price of Terayon shares caused by defendants' publication of false and materially misleading information, on November 6, 2003, Terayon published a release announcing defendants' intention to sell 10.8 million shares of equity to the public in a registered offering.<sup>1</sup> Gross proceeds from this sale were expected to be at least \$75.0 million – not including a 15% over-subscription allotment.

Form 10-Q for Third Quarter 2003

135. On or about November 10, 2003, defendants filed with the SEC the Company's Form 10-Q for the quarter ended September 30, 2003 ("3Q:03 Form 10-Q"), signed by defendant Taylor and certified by defendants Taylor and Zaki Rakib. In addition to making substantially similar statements concerning the Company's operations as were contained in Terayon's October 22, 2003 release and conference call, the Company's the 3Q:03 Form 10-Q also stated, in part, the following:

*The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X.... In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial statements at September 30, 2003 and for the three and nine months ended September 30, 2003 and 2002 have been included. [Emphasis added.]*

136. The Company's 3Q:03 Form 10-Q reported Terayon's Liquidity and Capital Resources, in part, as follows:

*At September 30, 2003, we had approximately \$42.4 million in cash and cash equivalents and \$107.0 million in short-term investments. As of September 30, 2003, we had approximately \$68.4 million of long-term obligations, principally relating to our 5% Convertible Subordinated Notes.*

*In July 2000, we issued \$500 million of 5% Convertible Subordinated Notes, or Notes, due in August 2007, resulting in net proceeds to us of approximately \$484.4 million. The Notes are our general unsecured obligation and are subordinated in right of payment to all of our existing and future senior indebtedness and to all of the*

<sup>1</sup> On November 14, 2003, as a result of an unfavorable reception by the institutional investment community, this offering was withdrawn. At that time, however, defendant Zaki Rakib stated that the withdrawal was not expected to adversely impact the Company because Terayon was "fortunate to be in a position where [it does] not need additional funds for operations."



1 liabilities of our subsidiaries. The Notes are convertible into shares of our common  
2 stock at a conversion price of \$84.01 per share at any time on or after October 24,  
3 2000 through maturity, unless previously redeemed or repurchased. Interest is  
4 payable semi-annually. *Debt issuance costs related to the Notes were approximately*  
5 *\$15.6 million.*

6 *Through September 30, 2003, we had repurchased approximately \$434.9 million*  
7 *of the Notes for \$171.0 million in cash and \$17.9 million in stock, resulting in a*  
8 *gain on early retirement of debt of approximately \$234.4 million net of related*  
9 *unamortized issuance costs of \$11.6 million.* We did not repurchase any Notes  
10 during the first nine months of 2003. [Emphasis added.]

11 137. The Company's 3Q:03 Form 10-Q also contained statements that attested to the  
12 adequacy of Terayon's purported controls and procedures. In this regard, the 3Q:03 Form 10-Q  
13 stated, in part, the following:

14 As of the end of the period covered by report, we carried out an evaluation, under the  
15 supervision and with the participation of our Chief Executive Officer and Chief  
16 Financial Officer, of the effectiveness of the design and operation of our disclosure  
17 controls and procedures. *Based on this evaluation, our Chief Executive Officer and*  
18 *Chief Financial Officer concluded that our disclosure controls and procedures are*  
19 *effective in timely alerting them to material information required to be presented*  
20 *in this report.* [Emphasis added.]

21 SOX Certifications Regarding First Quarter 2003

22 138. The Company's 3Q:03 Form 10-Q also contained SOX Certifications signed by  
23 defendants Taylor and Zaki Rakib and filed with the SEC. These Certifications stated, in part, "*the*  
24 *information contained in the Report fairly presents, in all material respects, the financial*  
25 *condition and results of operations of the Company at the dates and for the periods indicated.*"  
26 [Emphasis added.]

27 139. The statements made by defendants and contained in the Company's October 7, 2003  
28 and October 22, 2003 press releases, those statements made by defendants during the quarterly  
conference call, and those statements contained in Terayon's 3Q:03 Form 10-Q, were each  
materially false and misleading and were know by defendants to be false at that time, or were  
recklessly disregarded as such, for the reasons stated herein in ¶ 64.

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January 27, 2004 Release and Conference Call re FY:03

140. On January 27, 2004, Terayon published a release announcing results for the quarter ended December 31, 2003. This release provided financial information about the Company, in part, as follows:

**Terayon Reports Fourth Quarter and Full Year 2003 Results  
And Announces Restructuring to Enhance Path to Profitability**

Terayon Communication Systems, Inc. (Nasdaq: TERN), the leading innovator of intelligent broadband access, *today announced financial results in line with its previous guidance for the fourth quarter and year ended December 31, 2003.*

*Revenue for the fourth quarter of 2003 was \$43.0 million, a 70% increase compared to \$25.3 million for the same quarter a year ago, and a 14% increase compared to \$37.6 million for the third quarter of 2003.* Revenue for the twelve months ended December 31, 2003 was \$133.5 million, a 3% increase compared to \$129.4 million for the twelve months ended December 31, 2002.

*Net loss for the fourth quarter of 2003 was \$6.0 million, or \$0.08 per share, compared to a net loss of \$20.5 million, or \$0.28 per share, for the same quarter a year ago and a net loss of \$7.2 million, or \$0.10 per share, for the third quarter of 2003.* Net loss for the twelve months ended December 31, 2003 was \$50.4 million, or \$0.68 per share, compared to a net loss for the twelve months ended December 31, 2002 of \$44.2 million, or \$0.61 per share. [Emphasis added.]

141. The January 27, 2004 release also quoted defendant Zaki Rakib, in part, as follows:

*"2003 was a critical year of transition and milestone achievements for Terayon," said Zaki Rakib, Terayon's Chief Executive Officer. "We successfully completed the company migration from proprietary, baseline access products to standards-based and intelligent access products that lead the market, enabling broadband providers to deliver faster speeds and new services like voice and video conferencing through more economical, efficient networks. Further, we have begun to execute on our plan to expand the market applicability of intelligent access products as evidenced by our selection by FOX Network for its broadcast high definition distribution system for its affiliates nationwide beginning in 2004."*

\* \* \*

"Cable operators are responding to customer needs and competitive pressures by offering more bandwidth-intensive services such as faster high-speed data access, voice over the Internet (VoIP), HDTV, and Video on Demand in response to consumer and enterprise requirements and increasing competition from telecom and satellite operators," continued Rakib. *"Our goals for 2004 include: (1) capitalizing on our technology leadership and the opportunities created by these favorable market conditions to increase share across our CMTS, Subscriber and Digital Video businesses, (2) leveraging our best-of-breed digital video processing product*

line into other vertical markets including satellite, broadcast and telecom, and (3) achieving sustainable profitability through a combination of revenue growth, operational efficiencies, expense management, and strategic partnerships."

\* \* \*

"As we announced in December 2003, we are targeting profitability beginning in the second quarter of 2004. The steps we are taking now provide us with a clearer path towards this objective by lowering our breakeven revenue point, re-sequencing our R&D pipeline to better align with customer timing requirements, and improving our overall efficiency by streamlining the organization and bolstering core processes," said Doug Sabella, Terayon's Chief Operating Officer. "Now that we have introduced our CableLabs-certified, low cost IM6130 modem chip into production and established market acceptance of our Terayon BW 3000 DOCSIS 2.0-qualified CMTS product line, we are able to free up and re-deploy certain engineering and technical resources. We remain committed to our position as technology leader and innovator in the broadband access space, and to our reputation for unparalleled customer service and support." [Emphasis added.]

142. The January 27, 2004 release also reported the Company's Restructuring Activities that purportedly had recently taken place at the Company, including, the following:

#### **Restructuring Activities**

Terayon today announced its plans to reduce operating expenses and realign resources during the first quarter of 2004. This action is designed to advance the company towards sustainable profitability while retaining the resources necessary to drive innovation to capitalize on the growing market need for intelligent broadband access solutions. Related actions include: (1) a reduction in workforce of approximately 17%, or 70 employees, (2) the consolidation of certain facilities, (3) the write-down of related facility assets, and (4) a reduction in targeted areas of discretionary spending. The effect of these actions is expected to yield annualized operating savings of approximately \$10 million to \$12 million. Terayon expects to record a charge of approximately \$5 million to \$7 million in the quarter ending March 31, 2004 as a result of these actions.

#### 2003 Form 10-K

143. On or about March 15, 2004, defendants filed with the SEC the Company's 2003 Form 10-K for fourth quarter and fiscal year ended December 31, 2003, signed by defendants Zaki Rakib, Taylor, Shlomo Rakib, Solomon, Woodrow, and Slaven. In addition to making substantially similar statements concerning the Company's operations as had been announced by defendants on January 27, 2004, the 2003 Form 10-K also contained additional statements attesting to the critical accounting policies that were purported to then be in place at Terayon, including its revenue recognition policies, in part, as follows:

## Critical Accounting Policies

We consider certain accounting policies related to our use of estimates, revenue recognition, bad debt reserves, inventory valuation, impairment of long-lived assets, warranty returns, restructuring, income taxes and contingencies to be critical policies due to the estimation processes involved in each. We discuss each of our critical accounting policies, in addition to certain less significant accounting policies, with senior members of management and the audit committee, as appropriate.

**Use of Estimates.** The preparation of the consolidated financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires us to establish accounting policies that contain estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. *We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources.* These policies include:

- *revenue recognition;*
- the allowance for doubtful accounts, which impacts revenue;
- the valuation of exposures associated with the contract manufacturing operations and estimating future warranty costs, which impact cost of good sold and gross margins; and
- *the valuation of certain long-lived assets, especially goodwill and other purchased intangible assets, which has resulted in impairment, which impacts operating expenses.*

\* \* \*

**Revenue Recognition.** We recognize revenue in accordance with SEC Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" (SAB 101), as amended by *SAB 101A and 101B and updated by SAB 104. SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (4) is based on management's judgments regarding the collectibility of the selling price.* Should there be changes to management's judgments, revenue recognized for any reporting period could be adversely affected.

\* \* \*

Revenue arrangements with resellers are generally recognized when product is shipped to the resellers as we generally do not grant return rights beyond those provided by the warranty. [Emphasis added.]



144. The Company's 2003 Form 10-K also reported Terayon's Liquidity and Capital Resources, in part, as follows:

*At December 31, 2003, we had approximately \$30.2 million in cash and cash equivalents and \$108.5 million in short-term investments.*

\* \* \*

*In July 2000, we issued \$500 million of Notes, resulting in net proceeds to us of approximately \$484.4 million. The Notes are our general unsecured obligation and are subordinated in right of payment to all of our existing and future senior indebtedness and to all of the liabilities of our subsidiaries. The Notes are convertible into shares of our common stock at a conversion price of \$84.01 per share at any time on or after October 24, 2000 through maturity, unless previously redeemed or repurchased. Interest is payable semi-annually. Debt issuance costs related to the Notes were approximately \$15.6 million.*

*Through December 31, 2003, we had repurchased approximately \$434.9 million of the Notes for \$171.0 million in cash and \$17.9 million in stock, resulting in a gain on early retirement of debt of approximately \$234.4 million net of related unamortized issuance costs of \$11.6 million. No Notes were repurchased in 2003. [Emphasis added.]*

145. Regarding the Company's 5% Convertible Subordinated Notes, the Form 2003 10-K stated, in part, the following:

#### **Convertible Subordinated Notes**

*In July 2000, the Company issued \$500 million of 5% Convertible Subordinated Notes (Notes) due in August 2007 resulting in net proceeds to the Company of approximately \$484.4 million. The Notes are the Company's general unsecured obligation and are subordinated in right of payment to all existing and future senior indebtedness and to all of the liabilities of the Company's subsidiaries. The Notes are convertible into shares of the Company's common stock at a conversion price of \$84.01 per share at any time on or after October 24, 2000 through maturity, unless previously redeemed or repurchased. The Company could have redeemed some or all of the Notes at any time on or after October 24, 2000 and before August 7, 2003 at a redemption price of \$1,000 per \$1,000 principal amount of the Notes, plus accrued and unpaid interest, if any, if the closing price of the Company's stock exceeded 150% of the conversion price, or \$126.01 for at least 20 trading days within a period of 30 consecutive trading days ending on the trading day prior to the date of mailing of the redemption notice. The Company would also make an additional payment of \$193.55 per \$1,000 principal amount of the Notes, less the amount of any interest actually paid on the Notes before the date of redemption. The Company may redeem the Notes at any time on or after August 7, 2003 at specified prices plus accrued and unpaid interest. Interest is payable semi-annually. Debt issuance costs related to the Notes were approximately \$15.6 million and are amortized over seven years. At December 31, 2003, amortization of debt issuance costs totaled \$14.5 million.*

*In 2002, the Company repurchased approximately \$109.1 million of the Notes for \$57.6 million in cash, resulting in a gain of approximately \$49.1 million, net of related unamortized issuance costs of \$2.4 million. In 2001, the Company repurchased approximately \$325.9 million of the Notes for \$113.4 million in cash*



1 *and \$17.9 million in stock, resulting in a gain of approximately \$185.3 million, net*  
 2 *of related unamortized issuance costs of \$9.3 million.* The Company did not  
 3 repurchase any Notes during 2003. [Emphasis added.]

4 146. The Company's 2003 Form 10-K also contained statements that purported to attest to  
 5 the adequacy of Terayon's controls and procedures, in part, as follows:

6 As of the end of the period covered by this Annual Report on Form 10-K, the  
 7 Company carried out an evaluation, under the supervision and with the participation  
 8 of the Company's Disclosure Committee and the Company's management, including  
 9 the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of  
 10 the design and operation of the Company's disclosure controls and procedures  
 11 pursuant to Exchange Act Rules 13a-15(b) and 15d-15(b); and whether any change  
 12 has occurred in the Company's internal control over financial reporting pursuant to  
 13 Exchange Act Rules 13a-15(d) and 15d-15(d). *Based upon that evaluation, the*  
 14 *Chief Executive Officer and the Chief Financial Officer concluded that the*  
 15 *Company's disclosure controls and procedures are effective in timely alerting them*  
 16 *to material information relating to the Company (including its consolidated*  
 17 *subsidiaries) required to be included in the Company's periodic Securities and*  
 18 *Exchange Commission filings; and that no change in the Company's internal*  
 19 *control over financial reporting occurred during the Company's most recent fiscal*  
 20 *quarter that materially affected, or is reasonably likely to materially affect, the*  
 21 *Company's internal control over financial reporting.* [Emphasis added.]

22 SOX Certifications Regarding 2003 Form 10-K

23 147. The Company's Form 10-K for 2003 also contained SOX Certifications signed by  
 24 defendants Taylor and Zaki Rakib and filed with the SEC. These Certifications stated, in part, "*the*  
 25 *information contained in the Report fairly presents, in all material respects, the financial*  
 26 *condition and results of operations of the Company at the dates and for the periods indicated.*"  
 27 [Emphasis added.]

28 January 23, 2004 Ernst & Young Report

148. For full year 2003, Ernst & Young charged the Company over \$500,000 for audit  
 related fees. After completing that review at year end 2003, Ernst & Young provided a report to the  
 Board of Directors and Stockholders of the Company that stated, in part, as follows:

*We have audited the accompanying consolidated balance sheets of Terayon*  
*Communication Systems, Inc. as of December 31, 2003 and 2002, and the related*  
*consolidated statements of operations, stockholders' equity, and cash flows for*  
*each of the three years in the period ended December 31, 2003....We conducted*  
*our audits in accordance with auditing standards generally accepted in the United*  
*States. Those standards require that we plan and perform the audit to obtain*  
*reasonable assurance about whether the financial statements are free of material*  
*misstatement....We believe that our audits provide a reasonable basis for our*  
*opinion.*

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*In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Terayon Communication Systems, Inc. at December 31, 2003 and 2002, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States....*

149. The statements made by defendants and contained in the Company's December 8, 2003 and January 14, 2004 press releases, those statements made by defendants during the quarterly conference call, and those statements contained in Terayon's 2003 Form 10-K, were each materially false and misleading and were known by defendants to be false at that time, or were recklessly disregarded as such, for the reasons stated herein in ¶ 64.

*April 29, 2004 Release and Conference Call Regarding Results for 1Q:04*

150. On April 29, 2004, Terayon published a release announcing results for the quarter ended March 31, 2004. This release provided financial information about the Company, in part, as follows:

Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading provider of broadband access, delivery and management solutions, *today reported financial results in line with prior guidance for the quarter ended March 31, 2004.*

*Revenues for the first quarter of 2004 were \$41.2 million, an increase of 85% compared to \$22.3 million for the first quarter of 2003, and a decrease of 4% from \$43.0 million for the fourth quarter of 2003. Net loss for the first quarter of 2004 was \$10.2 million, or \$0.14 per share, which compares to a net loss of \$24.0 million, or \$0.33 per share, for the first quarter of 2003 and a net loss of \$6.0 million, or \$0.08 per share, for the fourth quarter of 2003.* The results for the first quarter of 2004 include a charge of \$3.4 million, or \$0.05 per share, related to restructuring activities and related asset write-offs. The results for the fourth quarter of 2003 include a non-operating gain of \$0.01 per share related to a favorable litigation settlement. [Emphasis added.]

151. The Company's April 29, 2004 release also quoted defendant Zaki Rakib, in part, as follows:

*"We are pleased with the performance of our digital video solutions and subscriber product lines, which had higher than anticipated sales for the quarter. While our CMTS sales in North America were also strong, they were offset by weaker CMTS sales in Asia as several customers extended their original deployment timeframes,"* said Zaki Rakib, Terayon's Chief Executive Officer. "Important milestones for us during the quarter include: (i) the introduction of our award-winning Terayon BP 5100-HD broadcast platform, and its adoption by FOX Broadcasting Company to power their HDTV delivery system; (ii) a record number of shipments of our TJ 700 family of DOCSIS 2.0-certified modems, which we believe will further solidify our

position as number two worldwide cable modem supplier as first reported by Kinetic Strategies for the fourth quarter of 2003; and (iii) surpassing the 2,500 unit shipment mark for DOCSIS 2.0 CMTS line cards since our qualification by CableLabs in December 2002. *Going forward, we believe having the only proven end-to-end DOCSIS 2.0 solution and the best-of-breed digital video processing product line positions us to capitalize on the accelerating growth of new, bandwidth-intensive service offerings such as HDTV, VOD, VoIP and commercial services.* [Emphasis added.]

152. The Company's April 29, 2004 release also provided an update on the Company's purported Restructuring Activities, in part, as follows:

#### **Restructuring Activities**

The first quarter 2004 restructuring activities announced by Terayon on January 27, 2004 have extended into the second quarter of 2004. During the first quarter of 2004 Terayon recognized a \$3.4 million charge related to first quarter restructuring activities, as compared to the original estimated charge of \$5 million to \$7 million. During the second quarter of 2004 Terayon expects to record an additional charge of approximately \$1.5 million to \$2.0 million related to the completion of these restructuring activities. The cumulative effect of the actions taken over the first and second quarters of 2004 is expected to yield annualized operating savings of approximately \$10 million beginning in the second quarter of 2004.

*For the second quarter of 2004, Terayon expects to report revenues in the range of \$42 million to \$46 million and anticipates a net loss in the range of \$0.02 to \$0.04 per share, excluding the effects of the estimated \$1.5 million to \$2.0 million charge.* Including the effects of the estimated charge, the net loss is expected to be in the range of \$0.04 to \$0.07 per share. [Emphasis added.]

153. Later the same day, on April 29, 2004, defendants also conducted a conference call for analysts and investors, hosted by defendants Taylor and Zaki Rakib. During this call, defendants reiterated the same or substantially similar material false and misleading statements concerning Terayon's revenues, earnings, gross margins and projected growth, as had been made previously and contained in the Company's press releases and SEC filings. In addition, during this call, defendant Rakib also stated, in part, the following:

**ZAKI RAKIB, CEO, TERAYON COMMUNICATION SYSTEMS:** Hello. Thank you for joining us. *I'm pleased to report that our financial results for the first-quarter were in line with our previous guidance. Art will provide additional details on these results later in the call. I would like to begin by highlighting the progress that we made over the last few quarters toward achieving sustainable profitability.* First, we have been able to grow revenues across all three of our businesses compared to first quarter of last year driven by the introduction of our DOCSIS 2.0 qualified product CMTS, growing our market share in cable modem from the number five vendor worldwide a year ago to the number two position today, and capitalizing on the increased demand for digital video band width management and ad-insertion solutions with cable and satellite operators and most recently extending these



offerings into the broadcast sector. Secondly, we have been able to improve gross margins over the past year through improved product mix, transitioning to lower cost manufacturing environments and implementing product cost reduction programs.

**While not there yet, we believe we are closing in on the target gross model as Art will outline for you later.** Finally over the last year we have taken strong measures to lower our operating expenses through head count reductions, resequencing of engineering programs, facility consolidations and other cost containment efforts. Our Q1 R&D and SG&A expenses are down 18% compared to Q1 of last year. **Revenues are up 85%.**

**We are pleased with the improving trend in our performance over the past year and anticipate making significant progress in Q2 towards achieving sustainable profitability.** We continue focusing on tight execution and extending our market leadership through innovations and unparalleled customer service.

\* \* \*

**In summary, I am pleased with the progress made over the past year in improving our operating performance and bringing innovation to the marketplace.** We are excited about the opportunities we believe are opening up to us for through the market dynamics being experienced by the cable, Teleco, and satellite providers. We continue to focus our efforts on execution to ensure that we're able to capitalize on these opportunities and drive towards sustainable profitability. With that, I would like to turn the call over to Art who will review the our first-quarter financial results in detail. [Emphasis added.]

154. Also, during the April 29, 2004 conference call, defendant Taylor also stated, in part, the following:

ART TAYLOR: Thank you Zaki. I would like to present our financial highlights for the first-quarter and follow-up with our revenue and loss per share expectations for the second-quarter of 2004. **Today we reported net revenues of 41.2 million for the first quarter in line with our previous guidance. This is also is an 85% increase compared to the 22.3 million in net revenues for the same quarter last year and a 4% sequential decrease from the 43 million posted in Q4 last year.**

\* \* \*

**Moving down the balance sheet, total current liabilities decreased by 7.2 million to 48.2 million versus the prior quarter due mainly for payments for inventory purchases.** We ended the quarter with 367 employees compared to 423 as of the end of December. As previously discussed, we eliminated approximately 60 positions during the quarter, which was partially offset by head count additions reflecting the increased emphasis that we are placing this area in 2004... [Emphasis added.]



Form 10-Q for First Quarter 2004

155. On or about May 10, 2004, defendants filed with the SEC the Company's Form 10-Q for the quarter ended March 31, 2004 ("1Q:04 Form 10-Q"), signed by defendant Taylor and certified by defendants Taylor and Zaki Rakib. In addition to making substantially similar statements concerning the Company's operations as were contained in Terayon's April 29, 2004 release, the Company's the 1Q:04 Form 10-Q also stated, in part, the following:

*The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X.... In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial statements at March 31, 2004 and for the three months ended March 31, 2004 and 2003 have been included.*  
[Emphasis added.]

The Company's 1Q:04 Form 10-Q also contained statements attesting to Terayon's Liquidity and Capital Resources that were purported to exist at that time.

**Liquidity and Capital Resources**

At March 31, 2004, we had approximately \$76.1 million in cash and cash equivalents and \$47.2 million in short-term investments.

\* \* \*

*In July 2000, we issued \$500.0 million of Notes, resulting in net proceeds to us of approximately \$484.4 million.* The Notes are a general unsecured obligation and are subordinated in right of payment to all of our existing and future senior indebtedness and to all of the liabilities of our subsidiaries. The Notes are convertible into shares of our common stock at a conversion price of \$84.01 per share at any time on or after October 24, 2000 through maturity, unless previously redeemed or repurchased. Interest is payable semi-annually. *Debt issuance costs related to the Notes were approximately \$15.6 million.*

*Through March 31, 2004, we had repurchased approximately \$434.9 million of the Notes for \$171.0 million in cash and \$17.9 million in stock, resulting in a gain on early retirement of debt of approximately \$234.4 million* net of related unamortized issuance costs of \$11.6 million. [Emphasis added.]

156. The Company's 1Q:04 Form 10-Q also contained statements that purported to attest to the adequacy of Terayon's controls and procedures, as follows:

1                                   **ITEM 4. CONTROLS AND PROCEDURES**

2           As of the end of the period covered by report, we carried out an evaluation, under the  
3           supervision and with the participation of our Chief Executive Officer and Chief  
4           Financial Officer, of the effectiveness of the design and operation of our disclosure  
5           controls and procedures. ***Based on this evaluation, our Chief Executive Officer and  
6           Chief Financial Officer concluded that our disclosure controls and procedures are  
7           effective in timely alerting them to material information required to be presented  
8           in this report.***

9           ***There has been no change in our internal controls over financial reporting that  
10           occurred during our most recent fiscal quarter that has materially affected or is  
11           reasonably likely to materially affect our internal controls over financial reporting.***  
12           [Emphasis added.]

13                                   SOX Certifications Regarding First Quarter 2004

14           157. The Company's 1Q:04 Form 10-Q also contained SOX Certifications signed by  
15           defendants Taylor and Zaki Rakib and filed with the SEC. These Certifications stated, in part, "***the  
16           information contained in the Report fairly presents, in all material respects, the financial  
17           condition and results of operations of the Company at the dates and for the periods indicated.***"  
18           [Emphasis added.]

19           158. The statements made by defendants and contained in the Company's April 29, 2004  
20           press release, those statements made by defendants during the quarterly conference call, and those  
21           statements contained in Terayon's 1Q:04 Form 10-Q, were each materially false and misleading and  
22           were known by defendants to be false at that time, or were recklessly disregarded as such, for the  
23           reasons stated herein in ¶ 64.

24                                   Resignation of Zaki Rakib

25           159. On May 27 2004, Terayon announced the resignation of defendant Zaki Rakib as  
26           CEO of the Company, effective August 31, 2004, as well as the expansion of the Board of Directors  
27           to include defendant Speaks. Upon the effectiveness of this resignation, defendant Zaki Rakib was  
28           appointed Chairman of the Board of Directors of Terayon, replacing Shlomo Rakib in that capacity.  
29           Defendant Shlomo Rakib continued to serve as President, Chief Technology Officer, and a member  
30           of the Board of Directors. At that time, defendants also characterized Zaki Rakib's resignation as  
31           being for "family reasons," and he was quoted in the Company's release as follows:

1 *"For the past 10 years, I have dedicated my time, my energy and my focus to*  
 2 *Terayon, in large part at the expense of attention to my family. I feel now is the*  
 3 *time to reverse the order of my priorities," said Dr. Rakib. "I have led Terayon*  
 4 *through its phenomenal growth phase and through its survival of the*  
 5 *telecommunication industry's recession to where it is now – back on the path to*  
 6 *growth. I pass to my successor the helm of a strong organization with a healthy*  
*balance sheet; an organization recognized for its leadership in digital video, and*  
*pioneering efforts in high-speed cable data. Terayon's leadership position in many*  
*product areas, combined with its technology assets can deliver on promises to*  
*customers and shareholders."* [Emphasis added.]

7 *June 14, 2004 Announcement of Retirement of Defendant Sabella as COO*

8 160. On June 14, 2004, defendant Sabella also announced his retirement as Chief  
 9 Operation Officer of the Company, effective July 16, 2004. While defendant Sabella had served as  
 10 COO of the Company since July 2003, according to the Company's release, his sudden and  
 11 unscheduled departure from the Company had occurred so that he too could "pursue other interests."

12 *July 26, 2004 Releases and Conference Call Regarding Results for 2Q:04.*  
 13 *Resignation of CFO Arthur Taylor*

14 161. On July 26, 2004, Terayon published a release announcing results for the quarter  
 15 ended June 30, 2004. This release provided financial information about the Company, in part, as  
 16 follows:

17 Terayon Communication Systems, Inc. (Nasdaq: TERN), a leading provider of  
 18 broadband access, delivery and management platforms, *today reported financial*  
*results in line with previous guidance for the quarter ended June 30, 2004.*

19 *Revenues for the second quarter of 2004 were \$42.8 million, an increase of 40%*  
 20 *compared to \$30.6 million for the second quarter of 2003, and an increase of 4%*  
 21 *from \$41.2 million for the first quarter of 2004. Net loss for the second quarter of*  
 22 *2004 was \$4.9 million, or \$0.06 per share, which compares favorably to a net loss*  
 23 *of \$13.1 million, or \$0.18 per share, for the second quarter of 2003 and a net loss*  
 24 *of \$10.2 million, or \$0.14 per share, for the first quarter of 2004. The results for the*  
*second quarter of 2004 include a charge of \$3.6 million, or \$0.04 per share, related to*  
*restructuring activities and executive separation payments. The results for the first*  
*quarter of 2004 included a charge of \$3.4 million, or \$0.05 per share, related to*  
*restructuring activities and related asset write-offs.* [Emphasis added.]

25 162. The Company's July 26, 2004 release also quoted defendant Zaki Rakib, in part, as  
 26 follows:

27 *"We are pleased with the record sales of our Digital Video Solutions product line,*  
 28 *and the strong sales performance of our Subscriber product line,"* said Zaki Rakib,  
 Terayon's Chief Executive Officer. "Our video business is benefiting from the



1 increased number of HDTV offerings by cable and satellite operators, combined with  
 2 growing demand for the Terayon CherryPicker's unique digital ad insertion  
 3 capabilities. While our CMTS sales were weaker than expected due to slower than  
 4 anticipated deployments from existing customers - particularly in Asia and to a lesser  
 5 degree in Europe - combined with increased competition, *we believe recent actions  
 6 we've undertaken will enable us to improve our sales execution and win new  
 7 business in these regions.*"

8 \* \* \*

9 "Today we've also announced that Jerry Chase is joining Terayon as its new  
 10 CEO. *We believe that under Jerry, Terayon is well positioned to capitalize on its  
 11 leadership in digital video solutions and on our one year plus industry leadership  
 12 in delivering the only end to end DOCSIS 2.0 solutions as cable operators  
 13 accelerate the roll out of advanced services to their customers.*" said Rakib. "In my  
 14 new role as Chairman of the Board, I look forward to assisting Terayon achieve its  
 15 mission of bringing the power of broadband to anyone, anywhere, at any time."  
 16 [Emphasis added.]

17 163. The Company's July 26, 2004 release also provided a Management Update, in part,  
 18 as follows:

#### 19 Management Updates

20 In a separate press release today, Terayon announced the appointment of Jerry D.  
 21 Chase as Chief Executive Officer.

22 Today, Terayon also announced the resignation of Arthur T. Taylor from his role as  
 23 Senior Vice President, CFO. Taylor is leaving to assume the role of CFO of a larger,  
 24 publicly traded company. Edward Lopez, Terayon's Senior Vice President, General  
 25 Counsel since 1999, has been appointed acting CFO. Terayon has begun a search for  
 26 Taylor's successor.

27 164. Later the same day, on July 26, 2004, defendants also conducted a conference call for  
 28 analysts and investors, hosted by defendants Taylor and Zaki Rakib. During this call, defendants  
 reiterated the same or substantially similar material false and misleading statements concerning  
 Terayon's revenues, earnings, and gross margins as had been made previously and contained in the  
 Company's press releases and SEC filings. In addition, during this call, defendant Rakib also stated,  
 in part, the following:

**ZAKI RAKIB, CEO, TERAYON COMMUNICATION SYSTEMS:** Good  
 afternoon everyone and thank you for joining us. Today we are reporting financial  
 results for the second quarter that are in-line with our previous guidance. *Revenues  
 were \$42.8 million and the reported loss per share is 6 cents. As you will note our  
 loss per share excluding restructuring and special charges was 2 cents, which was  
 at the favorable end of the 2 to 4 cent guidance range we targeted on our last  
 earnings call. It also is a substantial improvement over Q1's 9 cent loss per share*



1 *performance on a comparable basis.* Art will provide additional details on the  
2 financials later on the call.

3 \* \* \*

4 *In summary, I am pleased with the progress made over the past quarter and in*  
5 *bringing innovation to the marketplace.* We continue to monitor the opportunit-ies  
6 *we believe are opening up for us through the market dynamics being experienced by*  
7 *the cable, telco, satellite providers and broadcasters. We continue to focus our*  
8 *efforts on execution to ensure we are able to capitalize on these opportunities and*  
9 *drive towards sustainable profitability.* [Emphasis added.]

10 165. Also, during the July 26, 2004 conference call, defendant Taylor also stated, in part,  
11 the following:

12 ARTHUR TAYLOR: I would like now to present our financial highlights for the  
13 second quarter ....

14 Today we reported net revenues of 42.8 million for the second quarter, in line with  
15 our previous guidance. This is a 40 percent increase compared to the 30.6 million in  
16 net revenues recorded for the same quarter last year, and a 4 percent sequential  
17 increase from the 41.2 million posted in Q1. [Emphasis added.]

18 Form 10-Q for Second Quarter 2004

19 166. On or about July 27, 2004, defendants filed with the SEC the Company's Form 10-Q  
20 for the quarter ended June 30, 2004 ("2Q:04 Form 10-Q"), signed by defendant Taylor and certified  
21 by defendants Taylor and Zaki Rakib. In addition to making substantially similar statements  
22 concerning the Company's operations as were contained in Terayon's July 26, 2004 release, the  
23 2Q:04 Form 10-Q also stated, in part, the following:

24 *The accompanying condensed consolidated financial statements have been*  
25 *prepared in accordance with generally accepted accounting principles in the*  
26 *United States for interim financial information and in accordance with the*  
27 *instructions to Form 10-Q and Article 10 of Regulation S-X.... In the opinion of*  
28 *management, all adjustments (consisting of normal recurring adjustments)*  
*necessary for a fair presentation of the financial statements at June 30, 2004 and*  
*for the three and six months ended June 30, 2004 and 2003 have been included.*

\* \* \*

**Critical Accounting Policies**

*There have been no material change to any of our critical accounting policies and*  
*estimates* as disclosed in our annual report on Form 10-K for the year ended  
December 31, 2003. [Emphasis added.]

1 167. The Company's 2Q:04 Form 10-Q also reported Terayon's Liquidity and Capital  
2 Resources, in part, as follows:

3 At June 30, 2004, we had approximately \$47.8 million in cash and cash equivalents  
4 and \$68.5 million in short-term investments.

5 \* \* \*

6 *In July 2000, we issued \$500.0 million of Notes, resulting in net proceeds to us of*  
7 *approximately \$484.4 million. The Notes are a general unsecured obligation and*  
8 *are subordinated in right of payment to all of our existing and future senior*  
9 *indebtedness and to all of the liabilities of our subsidiaries. The Notes are*  
10 *convertible into shares of our common stock at a conversion price of \$84.01 per*  
11 *share at any time on or after October 24, 2000 through maturity, unless previously*  
12 *redeemed or repurchased. Interest is payable semi-annually. Debt issuance costs*  
13 *related to the Notes were approximately \$15.5 million.*

14 *Through June 30, 2004, we had repurchased approximately \$434.9 million of the*  
15 *Notes for \$171.0 million in cash and \$17.9 million in stock, resulting in a gain on*  
16 *early retirement of debt of approximately \$234.4 million net of related*  
17 *unamortized issuance costs of \$11.6 million. We did not repurchase any Notes in*  
18 *2003 or 2004. [Emphasis added.]*

19 168. The Company's 2Q:04 Form 10-Q also contained statements that purported to attest  
20 to the adequacy of Terayon's controls and procedures. In this regard, the 2Q:04 Form 10-Q stated,  
21 in part, the following:

22 As of the end of the period covered by report, we carried out an evaluation, under the  
23 supervision and with the participation of our Chief Executive Officer and Chief  
24 Financial Officer, of the effectiveness of the design and operation of our disclosure  
25 controls and procedures. *Based on this evaluation, our Chief Executive Officer and*  
26 *Chief Financial Officer concluded that our disclosure controls and procedures are*  
27 *effective in timely alerting them to material information required to be presented*  
28 *in this report.*

*There has been no change in our internal controls over financial reporting that*  
*occurred during our most recent fiscal quarter that has materially affected or is*  
*reasonably likely to materially affect our internal controls over financial reporting.*  
[Emphasis added.]

*SOX Certifications for Second Quarter of 2004 by Taylor and Zaki Rakib*

169. The Company's 2Q:04 Form 10-Q also contained SOX Certifications signed by  
defendants Taylor and Zaki Rakib and filed with the SEC. These Certifications stated, in part, "*the*  
*information contained in the Report fairly presents, in all material respects, the financial*  
*condition and results of operations of the Company at the dates and for the periods indicated.*"  
[Emphasis added.]

170. The statements made by defendants and contained in the Company's May 27, 2004 and July 26, 2004 press releases, those statements made by defendants during the quarterly conference call, and those statements contained in Terayon's 2Q:04 Form 10-Q, were each materially false and misleading and were know by defendants to be false at that time, or were recklessly disregarded as such, for the reasons stated herein in ¶ 64.

Press Release and Conference Call Regarding "Record" Third Quarter 2004 Results

171. On October 28, 2004, Terayon published a release announcing results for the quarter ended September 30, 2004. This release provided financial information about the Company, in part, as follows:

*Revenues for the third quarter of 2004 were \$37.2 million, down 1% from \$37.6 million in the third quarter of 2003, and down 13% from \$42.8 million in the second quarter of 2004.* Net loss for the third quarter of 2004 was \$13.5 million, or \$0.18 per share, as compared to a net loss of \$7.2 million, or \$0.10 per share, in the third quarter of 2003, and a net loss of \$4.9 million, or \$0.06 per share, in the second quarter of 2004. The results for the third quarter of 2004 include an inventory charge of \$7.3 million, or \$0.10 per share, primarily related to a write-down of excess CMTS inventory, and a charge of \$1.4 million, or \$0.02 per share, related to an executive separation payment. The results for the second quarter of 2004 included an inventory benefit of \$0.8 million, or \$0.01 per share, related to the sale of previously reserved inventory, and a charge of \$3.6 million, or \$0.04 per share, related to restructuring activities and executive separation payments.

The Digital Video Solutions product line had revenues of \$10.8 million in the third quarter of 2004, compared to \$4.6 million in the third quarter of 2003 and \$7.5 million in the second quarter of 2004. The Subscriber product line had revenues of \$19.8 million in the third quarter of 2004, compared to \$16.2 million in the third quarter of 2003 and \$25.0 million in the second quarter of 2004. The CMTS product line had revenues of \$6.6 million in the third quarter of 2004, compared to \$16.8 million in the third quarter of 2003 and \$10.3 million in the second quarter of 2004. [Emphasis added].

172. The Company's October 28, 2004 release also quoted defendant Chase, in part, as follows:

**"We are very pleased with our second consecutive quarter of record revenues in our Digital Video Solutions product line and the continued strong sales performance of our Subscriber product line,"** said Jerry Chase, CEO, Terayon. "Important milestones for us during the quarter include: (i) the debut of the Terayon BP 5100 as the enabling technology behind Fox Broadcasting Company's launch of high definition broadcasts of National Football League games, and (ii) the Euro-DOCSIS 2.0 certification of the Terayon TJ721X cable modem, which delivers another level of assurance to cable operators seeking to build more efficient networks that meet regional specifications. In contrast to those strong performances, we are



1 disappointed by our weak CMTS sales, which reflect slower deployments by existing  
2 customers and our ongoing challenge in winning new accounts."

3 \* \* \*

4 "Despite Terayon's undisputed technology leadership in the DOCSIS 2.0 CMTS  
5 market, we have been unable to successfully translate that into a profitable CMTS  
6 market leadership position," said Chase. "After careful evaluation of Terayon's  
7 overall product portfolio and strategy, we have decided to cease further investment in  
8 our CMTS product line and halt development on future hardware upgrades.<sup>2</sup> We  
9 intend to work with existing customers to create agreeable support plans and  
10 minimize disruption."

11 **"These changes do not alter our vision for the company," said Chase. "Terayon  
12 continues to provide broadband solutions for video, voice and data through its  
13 existing Digital Video and Subscriber product lines, and we will leverage our head-  
14 end intellectual property through our advanced technology group as market  
15 opportunities arise in the future."**

16 "As we look to future quarters, we see significant growth opportunities in our Digital  
17 Video Solutions product line driven by increased HDTV offerings and the move  
18 from analog to digital content. In addition, we are seeing increased interest in more  
19 strategic applications of our digital video technology such as on-screen branding and  
20 customer-relevant digital ad insertion," continued Chase. "Our Subscriber product  
21 line should benefit from the accelerating rollout of VoIP services by cable operators  
22 as well as the continuing need to find new bandwidth within existing networks. We  
23 anticipate that our market leadership position and strong business models across both  
24 product lines will position us well to leverage these compelling market dynamics,  
25 which offer a significant growth opportunity and an accelerated path to profitability  
26 going forward." [Emphasis added.]

#### 27 10-Q for Third Quarter 2004

28 173. On or about November 15, 2004, defendants filed with the SEC the Company's Form  
10-Q for the quarter ended September 30, 2004 ("3Q:04 Form 10-Q"), signed and/or certified by  
defendants Chase and Lopez. In addition to making substantially similar statements concerning the

<sup>2</sup> By contrast, on November 18, 2004, it was reported that worldwide CMTS revenue was up  
an astounding 3% from 2Q04 to 3Q04, "triggered by a huge surge in cable IAD uptake," and "lifted  
by strong performances from Cisco Systems and Motorola in all regions, especially North America,"  
according to Infonetics Research Cable Aggregation Hardware quarterly market share and forecast  
report. According to this source, at that time, the worldwide CMTS market was projected to be  
\$673 million in 2007. The major drivers were more bandwidth for consumers and businesses and  
new packet telephone services. According to Michael Howard, principal analyst of Infonetics  
Research and lead author of Cable Aggregation Hardware, "Cable broadband subscriber growth in  
North America continues unabated, with all major MSOs showing healthy single-digit quarterly  
subscriber growth this year... MSOs are maintaining a competitive advantage, despite the  
momentum growing behind DSL..."



1 Company's operations as had been made by defendants previously, the Company's 3Q:04 Form 10-  
2 Q also stated, in part, the following:

3 *The accompanying condensed consolidated financial statements have been*  
4 *prepared in accordance with U.S. generally accepted accounting principles for*  
5 *interim financial information and in accordance with the instructions to Form 10-*  
6 *Q and Article 10 of Regulation S-X.... In the opinion of management, all*  
7 *adjustments (consisting of normal recurring adjustments) necessary for a fair*  
8 *presentation of the financial statements at September 30, 2004 and for the three*  
9 *and nine months ended September 30, 2004 and 2003 have been included.*  
10 [Emphasis added.]

11 174. The Company's 3Q:04 Form 10-Q also contained additional statements attesting to  
12 the "Critical Accounting Policies" that were purported to then be in place at Terayon, as follows:

13 **Critical Accounting Policies**

14 *There have been no material change to any of our critical accounting policies and*  
15 *estimates as disclosed in our annual report on Form 10-K for the year ended*  
16 *December 31, 2003. [Emphasis added.]*

17 175. The Company's 3Q:04 Form 10-Q also contained statements attesting to Terayon's  
18 Liquidity and Capital Resources that was purported to exist at that time, in part, as follows:

19 At September 30, 2004, we had approximately \$64.1 million in cash and cash  
20 equivalents and \$47.8 million in short-term investments.

21 \* \* \*

22 *In July 2000, we issued \$500.0 million of Notes, resulting in net proceeds to us of*  
23 *approximately \$484.4 million. The Notes are a general unsecured obligation and*  
24 *are subordinated in right of payment to all of our existing and future senior*  
25 *indebtedness and to all of the liabilities of our subsidiaries. The Notes are*  
26 *convertible into shares of our common stock at a conversion price of \$84.01 per*  
27 *share at any time on or after October 24, 2000 through maturity, unless previously*  
28 *redeemed or repurchased. Interest is payable semi-annually. Debt issuance costs*  
*related to the Notes were approximately \$15.5 million. [Emphasis added].*

176. The Company's 3Q:04 Form 10-Q also contained statements that purported to attest  
to the adequacy of Terayon's controls and procedures. *While the 3Q:04 Form 10-Q did*  
*acknowledge "a deficiency" in the Company's communications protocols, it also reported that*  
*this problem had been substantially remedied and that, following a review of the Board of*  
*Directors, the Company's internal controls and procedures were reasonably adequate.*

1 177. As evidence of this, the 3Q:04 Form 10-Q also stated, in part, the following:

2 As of the end of the period covered by this report, we carried out an evaluation,  
3 under the supervision and with the participation of our Chief Executive Officer and  
4 Chief Financial Officer, of the effectiveness of the design and operation of our  
5 disclosure controls and procedures. Based on this evaluation, our Chief Executive  
6 Officer and Chief Financial Officer identified *a deficiency in our disclosure controls  
7 and procedures as of September 30, 2004, due to an inadequacy of communication  
8 between certain parts of the organization and the finance department.* In  
9 connection with the review of our financial statements for the third quarter of 2004,  
10 Ernst & Young LLP, our independent registered public accountants, advised our  
11 Audit Committee that they considered this deficiency to be a material weakness  
12 under standards established by the Public Company Accounting Oversight Board.  
13 *This material weakness related to an accrual of severance for an executive officer  
14 in an incorrect reporting period, which Ernst & Young LLP believed to be related  
15 to the inadequacy of communication between certain parts of the organization and  
16 the finance department.* The accrual is reflected in the condensed consolidated  
17 financial statements for the three and nine month period ended September 30, 2004.

18 Under the direction of our Audit Committee and with the participation of our senior  
19 management, *we have taken steps designed to strengthen our disclosure controls  
20 and procedures and internal controls to address the material weakness identified  
21 by Ernst and Young. We have, on an immediate basis, taken steps to improve our  
22 internal controls and our control environment. We have implemented steps to  
23 ensure that senior members of our finance department review all press releases  
24 before they are released and all resignations of executive staff are communicated  
25 promptly to senior members of our finance department.* We will continue to  
26 monitor the communication channels between our senior management and our  
27 finance department and will take prompt action, as necessary, to further strengthen  
28 our disclosure controls and procedures and internal controls to comply with  
Sarbanes-Oxley compliance procedures. Moreover, we will continue our efforts to  
identify, assess and correct any additional material weaknesses in our internal  
controls.

19 *We believe the corrective steps taken to improve our disclosure controls and  
20 procedures and internal controls described above have enabled our Chief  
21 Executive Officer and Chief Financial Officer to conclude that our disclosure  
22 controls and procedures are now effective in timely alerting them to material  
23 information required to be included in this Quarterly Report on Form 10-Q for the  
24 quarter ended September 30, 2004.*

25 \* \* \*

26 We intend to review and evaluate the design and effectiveness of our disclosure  
27 controls and procedures on an ongoing basis and to improve our controls and  
28 procedures over time and to correct any deficiencies that we may discover in the  
future. Our goal is to ensure that our senior management has timely access to all  
material financial and non-financial information concerning our business. While *we  
believe the present design of our disclosure controls and procedures is effective to  
achieve our goal, future events affecting our business may cause us to significantly  
modify our disclosure controls and procedures.* [Emphasis added.]

178. The statements concerning the Company's controls and procedures were also critically important to investors as a result of the related-party nature of a material amount of the Company's revenues. Accordingly, the Company's 3Q:04 Form 10-Q described these related party transactions, in part, as follows:

**Related Party Transactions**

Lewis Solomon, a member of the Company's Board of Directors and a member of the Company's Nominating and Governance Committee and Compensation Committee, is also a member of the Board of Directors of Harmonic, Inc. (Harmonic). Harmonic is an authorized, non-exclusive reseller of certain of the Company's video products. For the three and nine months ended September 30, 2004, related party revenue included \$1.5 million and \$4.9 million, respectively, of revenue from Harmonic. For the three and nine months ended September 30, 2003, related party revenue included \$0.5 million and \$1.5 million, respectively, of revenue from Harmonic.

Alek Krstajic, a member of the Company's Board of Directors, was the Senior Vice President of Interactive Services, Sales and Product Development for Rogers Communications, Inc. (Rogers) until January 2003. Beginning April 1, 2003, the Company no longer recognized revenues related to Rogers as related party revenue because Rogers was no longer considered to be a related party. For the first quarter of 2003, the Company recognized \$1.4 million of Rogers's related party revenue, net of amortization of co-marketing expense.

In the nine months ended September 30, 2004, the Company paid Mr. Krstajic \$30,000 for consulting services provided to the Company.

In December 2001, the Company entered into a co-marketing arrangement with Rogers to promote the Company's brand its products. The Company paid \$0.9 million to Rogers, and recorded this amount as other current assets. In July 2002, the Company began amortizing this prepaid asset and charging it against revenue in accordance with the Emerging Issues Task Force 01-09, "Accounting for Consideration given by a Vendor to a Customer or Reseller in Connection with the Purchase or Promotion of the Vendor's Products." Amounts charged against revenues in the three and nine months ended September 30, 2003, totaled approximately \$1.4 million and \$4.2 million, respectively. This asset was fully amortized during 2003.

Cost of related party revenues in the Company's consolidated statements of operations consists of direct and indirect costs. Accounts receivable from Harmonic totaled approximately \$0.7 million at September 30, 2004. None of the related parties is a supplier to the Company.



Certifications for Third Quarter 2004

179. The Company's 3Q:04 Form 10-Q also contained SOX Certifications signed by defendants Chase and Lopez and filed with the SEC. These Certifications stated, in part, "*the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company at the dates and for the periods indicated.*"

[Emphasis added.]

180. The 3Q:04 Form 10-Q also contained additional Certifications by defendants Chase and Lopez that certified, in part, as follows:

*Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;*

*Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;*

\* \* \*

*[The registrant's other certifying officers and I] evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (11/14/02); and... presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;*

\* \* \*

*[The registrant's other certifying officers and I have disclosed] all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls...*

181. The statements contained in Terayon's October 28, 2004 release and those statements contained in the Company's 3Q:04 Form 10-Q, referenced above, were each materially false and misleading when made, and were known by defendants to be false at that time or were recklessly disregarded as such thereby, for the reasons stated herein, in ¶ 64.



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February 9, 2005 Release and Conference Call Regarding Results for 4Q and FY 2004

182. On February 9, 2005, Terayon published a release announcing results for the fourth quarter and full year ended December 31, 2004. This release announced very strong financial and operational results with purported digital video revenue growth of more than 100% year-over-year. In addition, this release also stated, in part, the following:

*Revenue for the fourth quarter of 2004 was \$29.4 million, down 32% compared to \$43.0 million for the same quarter a year ago, and a 21% decrease compared to the \$37.2 million for the third quarter 2004. Revenue for the 12 months ended December 31, 2004 was \$150.5 million, a 12.7% increase compared to \$133.5 million for the 12 months ended December 31, 2003.*

*Net loss for the fourth quarter of 2004 was \$7.9 million, or \$0.10 per share, compared to a net loss of \$6.0 million, or \$0.08 per share, for the same quarter a year ago, and a net loss of \$13.5 million, or \$0.18 per share, for the third quarter of 2004. Net loss for the 12 months ended December 31, 2004 was \$36.5 million, or \$0.48 per share, compared to a net loss for the 12 months ended December 31, 2003 of \$50.4 million, or \$0.68 per share. [Emphasis added.]*

183. Commenting on these purported strong financial results, defendants Chase and Richman were quoted in this release, as follows:

"Our fourth quarter results reflect our decision to focus Terayon on our digital video network applications and home access solutions and to cease investment in future development of our CMTS products. ***The strong performance of our digital video products during the fourth quarter and 2004 clearly shows why we have moved video to the center of our corporate strategy.***" said Jerry Chase, Terayon's Chief Executive Officer. "We took big steps in 2004 to strengthen our leadership in digital video networking by working with customers to accelerate their evolution to all-digital networks, expanding the market applicability for our solutions, and launching new and innovative products and functionality. Those actions resulted in a ***strong financial performance in the fourth quarter and 2004*** for digital video networking."

\* \* \*

***"Our restructuring activities and increased focus on cost management in 2004 will greatly benefit the company as we drive operations to positive net income",*** said Mark Richman, Terayon's Chief Financial Officer. ***"By focusing our capital and human resources on our growth market – digital video networking applications – we expect to deliver profitable top line growth to achieve net income profits and positive cash flow generation."*** [Emphasis added.]

///

///

///

1 184. Later the same day, on February 9, 2005, defendants also conducted a conference call  
 2 for analysts and investors, hosted by defendants Richman and Chase. During this call, defendant  
 3 Chase stated, in part, the following:

4 **JERRY CHASE, CEO, TERAYON COMMUNICATION SYSTEMS:** Hello,  
 5 everyone, and thank you for joining us for the Terayon Q4 and full 2004 earnings  
 6 conference call. I've now been with Terayon for about five months, and Mark, our  
 7 CFO, has been here for just a little over two months. During that short period of time  
 8 *we have begun to make many changes that will enable us to accentuate and build*  
 9 *on our strengths, move out of product lines in which we were underperforming*  
 10 *and put the Company on a track towards better financial performance.*

11 *I've shared with many people why I came to Terayon. I believe it had a unique*  
 12 *position and opportunity to be a part of the growing video market, and my belief is*  
 13 *stronger today than ever.* We believe that the proliferation of video applications will  
 14 correlate closely to how consumers and businesses have adopted mobile phones.  
 15 These video applications will be delivered across any network to any device at any  
 16 time, instant access.

17 During my call last October, we discussed the product evaluation criteria we are  
 18 using to evaluate sustainable, profitable corporate growth. They are, we must be the  
 19 market leader or a very strong influential player in the markets in which we compete.  
 20 Our customer base must be diversified buying now and have an ongoing plan to buy  
 21 from us, and also we must have the cost structure to grow earnings faster than sales.  
 22 *Our 2004 performance and several Q4 actions have put Terayon in a stronger*  
 23 *position on these three criteria and position us well for the path to sustainable*  
 24 *profitability.*

17 \* \* \*

18 **JERRY CHASE:** ...I'm optimistic about Terayon's ability to focus and deliver  
 19 favorably against our strategy and business model. It's a great time to be involved in  
 20 digital video and it truly will change how we communicate, entertain and stay  
 21 informed. Mark and I look forward to providing you with updates on our progress as  
 22 we transition Terayon to a digital video networking company.

23 185. During this call, defendant Richman also stated, in part, the following:

24 **MARK RICHMAN:** Thank you, Jerry. *I am very pleased to announce we've met or*  
 25 *exceeded all previously announced guidance as it relates to our P&L performance*  
 26 *objectives. Starting with our top line, today we reported net revenues of 29.4*  
 27 *million for the fourth quarter, a 32 percent decrease from the 43 million recorded*  
 28 *in the fourth quarter 2003 and down 21 percent sequentially from 37.2 million*  
 29 *reported in third quarter 2004. However, for the full year of 2004 we reported*  
 30 *150.5 million in revenues, a 12.7 percent increase compared to 133.5 million for*  
 31 *the 12 months ended December 2003.*

32 *The quarter over quarter decline in revenues is primarily attributable to reduction*  
 33 *in revenue from legacy product lines, including CMTS equipment sales. Legacy*

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1 product revenues declined to 3 million for the fourth quarter of 2004, down from  
2 20.5 million in the fourth quarter of 2003 and compared to 7.6 million in the third  
3 quarter of 2004.

4 \* \* \*

5 Including severance and separation charges, net loss for the fourth quarter was 7.9  
6 million or \$.10 per share as compared to a net loss of 6 million or \$.08 per share in  
7 the fourth quarter of 2003 and a net loss of 13.5 million or \$.18 per share in the third  
8 quarter of 2004. Excluding these charges, net loss for the quarter was 5.2 million or  
9 \$.07 per share. Net loss for the year was 36.5 million or \$.48 per share compared to a  
10 loss of 50.4 million or \$.68 per share in the 12 months ended December 31, 2003.  
11 [Emphasis added.]

12 186. The statements contained in the February 9, 2005 release and conference call  
13 regarding results for the Fourth Quarter and Fiscal Year 2004 were materially false and misleading  
14 for the reasons set forth in ¶ 64.

15 2004 Form 10-K

16 187. On or about March 8, 2005, defendants filed with the SEC the Company's 2004  
17 Form 10-K for the fourth quarter and full year ended December 31, 2004, certified by defendants  
18 Chase and Richman, and signed by defendants Chase, Richman, Zaki Rakib, Shlomo Rakib,  
19 Solomon, Krstajic, Woodrow, Slaven, Miller and Speaks. In addition to making statements  
20 substantially similar to those that had been made by defendants previously, concerning the  
21 Company's financial and operational results, the 2004 Form 10-K also stated, in part, the following:

22 **Net Loss Per Share**

23 Basic and diluted net loss per share was computed using the weighted average  
24 number of common shares outstanding. Options, warrants, restricted stock, and  
25 convertible debt were not included in the computation of diluted net loss per share  
26 because the effect would be anti-dilutive.

27 Shares used in the calculation of basic and diluted net loss per share are as follows  
28 (in thousands, except per share data):

29 ///

30 ///

31 ///

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	<u>Years Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Net Loss	<u>\$ (36,531)</u>	<u>\$ (50,353)</u>	<u>\$ (44,213)</u>
Shares used in computing basic and diluted net loss per share	<u>75,861</u>	<u>74,212</u>	<u>72,803</u>
Basic and diluted net loss per share	<u>\$ (0.48)</u>	<u>\$ (0.68)</u>	<u>\$ (0.61)</u>

188. Providing more "color" on the Company's revenues, the 2004 Form 10-K also reported Terayon's purported Revenue Recognition accounting policies, in part, as follows:

#### Revenue Recognition

The Company recognizes revenue in accordance with SEC Staff Accounting Bulletin (SAB) No. 104 "Revenue Recognition" ("SAB 104"). *SAB 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services were rendered; (3) the selling price is fixed or determinable; and (4) collectibility is reasonably assured.* [Emphasis added.]

189. The Company's 2004 Form 10-K also contained statements attesting to Terayon's Liquidity and Capital Resources that was purported to exist at that time, in part, as follows:

At December 31, 2004, we had approximately \$43.2 million in cash and cash equivalents and \$54.5 million in short-term investments.

\* \* \*

*In July 2000, we issued \$500 million of Notes, resulting in net proceeds to us of approximately \$484.4 million.* The Notes are our general unsecured obligation and are subordinated in right of payment to all of our existing and future senior indebtedness and to all of the liabilities of our subsidiaries. The Notes are convertible into shares of our common stock at a conversion price of \$84.01 per share at any time on or after October 24, 2000 through maturity on August 2007, unless previously redeemed or repurchased. Interest is payable semi-annually. *Debt issuance costs related to the Notes were approximately \$15.6 million.* [Emphasis added.]

190. In addition to the foregoing, the Company's 2004 Form 10-K also contained statements that attested to the purported adequacy of Terayon's controls and procedures. While the 2004 Form 10-K did again acknowledge minor defects in certain communications protocols, the 2004 Form 10-K also reported that this problem had been substantially remediated and that,



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1 following a review of the Board of Directors, the Company's internal controls and procedures were  
2 reasonably adequate. As evidence of this, the 2004 Form 10-K also stated, in part, the following:

3 *We maintain disclosure controls and procedures that are designed to ensure that*  
4 *information required to be disclosed in our reports under the Securities Exchange*  
5 *Act of 1934, as amended (Exchange Act), is recorded, processed, summarized and*  
6 *reported within the time periods specified in the Securities and Exchange*  
7 *Commission's (SEC) rules and forms, and that such information is accumulated*  
8 *and communicated to management, including our Chief Executive Officer (CEO)*  
9 *and Chief Financial Officer (CFO), as appropriate, to allow timely decisions*  
10 *regarding required disclosure....*

11 \* \* \*

12 As disclosed in our Quarterly Report on Form 10-Q for the period ended September  
13 30, 2004, in connection with the preparation of that report, we determined that, due  
14 to a deficiency in communication of financially significant information between  
15 certain parts of our organization and the finance department, our disclosure controls  
16 and procedures and internal controls over financial reporting were not effective.  
17 Particularly in the third quarter of 2004, the finance department did not review our  
18 press release and communication of information to our finance department regarding  
19 the resignation of an executive was not timely, which resulted in adjustments to the  
20 internal accounting for the executive's termination benefits. *As previously disclosed,*  
21 *under the direction of our Audit Committee and with the participation of our*  
22 *senior management, we took steps to ensure that senior members of our finance*  
23 *department review all press releases before they are released and undertook to*  
24 *enhance the communication between our senior management and our finance*  
25 *department to further strengthen our controls.*

26 *In connection with our review of our disclosure controls and procedures as of*  
27 *December 31, 2004, we determined that the controls implemented to enhance*  
28 *communication between our senior management and our finance department*  
29 *lacked sufficient documentation to permit verification of their operation. As a*  
30 *result, as discussed below in Management's Report on Internal Control over*  
31 *Financial Reporting, we have concluded that the aforementioned deficiency*  
32 *represents a material weakness in internal control over financial reporting as of*  
33 *December 31, 2004.*

34 In connection with our review of our disclosure controls and procedures as of  
35 December 31, 2004, we determined that procedures related to controls over the  
36 preparation and review of the Annual Report on Form 10-K were not effective, for  
37 the following reasons. *In the latter part of 2004 and in early 2005, key persons*  
38 *involved in the preparation and review of our periodic reports under the Exchange*  
39 *Act including the Controller and Assistant Controller responsible for SEC*  
40 *reporting departed the Company and we retained consultants to participate in the*  
41 *preparation of our Annual Report. This resulted in providing an initial draft of the*  
42 *financial statements and footnotes included in our Annual Report to our*  
43 *independent registered public accountants that did not provide adequate*  
44 *disclosures in the accompanying notes in accordance with GAAP. We have*  
45 *concluded that this deficiency represents a material weakness in internal control over*  
46 *financial reporting as of December 31, 2004.*

1 *Based on the evaluation of the effectiveness of the design and operation of our*  
 2 *disclosure controls and procedures, in light of the deficiencies described above,*  
 3 *our management, including our CEO and CFO, concluded that our disclosure*  
 4 *controls and procedures as of December 31, 2004 were not effective.*

5 \* \* \*

6 **Changes in internal control over financial reporting.**

7 *Other than as described above in the third paragraph of Evaluation of Disclosure*  
 8 *Controls and Procedures, there has been no change in our internal control over*  
 9 *financial reporting during our most recently completed fiscal quarter that has*  
 10 *materially affected or is likely to materially affect our internal control over financial*  
 11 *reporting.*

12 **Remediation Steps to Address Material Weaknesses.**

13 Subsequent to year end, we are taking the following steps to remediate the  
 14 deficiencies in our disclosure controls and procedures and material weaknesses in our  
 15 internal control over financial reporting identified above:

16 *Documentation of Internal Communication with Our Finance Department.* We  
 17 implemented procedures to document review of press releases and other financially  
 18 significant communications in accordance with the policy that we implemented in  
 19 connection with preparation of our Quarterly Report on Form 10-Q for the period  
 20 ended September 30, 2004.  
 21 Additional Experienced Finance Personnel. We are taking the following steps to  
 22 address our need for additional experienced finance personnel and to improve our  
 23 controls over financial reporting:

- 24 (i) a commitment to promptly hire a permanent Vice President of  
 Finance/controller;
- 25 (ii) hiring into our finance department an additional person with SEC  
 reporting experience;
- 26 (iii) increasing staffing in the finance department;
- 27 (iv) developing procedures to train new employees and/or consultants in  
 the finance department on our disclosure procedures and controls, our company and  
 our actions in the previous reporting periods; and
- 28 (v) improving the review process that occurs prior to providing the initial  
 draft of the periodic report to our independent auditors for review. [Emphasis added.]

191. The statements concerning the Company's controls and procedures were also  
 important to investors as a result of the related-party nature of a material amount of the Company's  
 revenues. Accordingly, again the Company's 2004 Form 10-K described these related party  
 transactions, in part, as follows:

### Related Party Transactions

During the years ended December 31, 2004, 2003 and 2002, the Company recognized revenue of \$9.9 million, \$4.7 million and \$9.1 million, respectively in connection with product shipments made to related parties. Related party revenues in 2004 were from Harmonic, Inc. (Harmonic). Related party revenues in 2003 and 2002 included revenues from Harmonic and Rogers Communications, Inc. (Rogers). Lewis Solomon, a member the Company's board of directors, is a member of the board of directors of Harmonic. All revenues attributable to Harmonic were included in related party revenues in 2004 and 2003. Alek Krstajic, another member of our board of directors, was the Senior Vice President of Interactive Services, Sales and Product Development for Rogers until January 2003. Effective in April 2003, Rogers was no longer a related party to us. Consequently, revenues attributable to Rogers are only classified as related party revenues in the first quarter of 2003. Neither of these related parties are a supplier to the Company.

Cost of related party product revenues in the Company's consolidated statements of operations consists of direct and indirect product costs. Accounts receivable from Rogers and Harmonic totaled approximately \$3.1 million and \$0.6 million at December 31, 2004 and 2003, respectively.

In December 2001, the Company entered into co-marketing arrangements with Shaw Communications, Inc. (Shaw) and Rogers. The Company paid \$7.5 million to Shaw and \$0.9 million to Rogers, and recorded these amounts as other current assets. In July 2002, the Company began amortizing these prepaid assets and charging them against related party revenues in accordance with EITF 01-09, "Accounting for Consideration given by a Vendor to a Customer or Reseller in Connection with the Purchase or Promotion of the Vendor's Products." The Company charged \$1.4 million per quarter of the amortization of these assets against total revenues through December 31, 2003. Amounts charged against total revenues in the year ended December 31, 2002 and December 31, 2003, totaled approximately \$2.8 million and \$5.6 million, respectively. Of the co-marketing amortization charged to total revenues, \$0.15 million and \$0.3 million were charged to related party revenues in the year ended 2003 and 2002, respectively. No further amounts of these co-marketing arrangements are included in other current assets at December 31, 2003 and no further amortization occurred in 2004.

In October 2002, the Company incurred a marketing expense of \$150,000 for Team Honor, an organization that supports a professional sailing team. One of the Company's Board members, Alek Krstajic is the founder and President of Team Honor.

### Certifications Regarding 2004 10-K

192. To further assure investors as to the purported accuracy and completeness of the Company's financial and operational reports, as well to further assure investors as to the adequacy of the Company's financial controls and operational procedures, the Company's 2004 Form 10-K also contained certifications by defendants Chase and Richman that certified, in part, as follows:

***Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the***



1 *statements made, in light of the circumstances under which such statements were*  
 2 *made, not misleading with respect to the period covered by this quarterly report;*

3 *Based on my knowledge, the financial statements, and other financial information*  
 4 *included in this quarterly report, fairly present in all material respects the*  
 5 *financial condition, results of operations and cash flows of the registrant as of,*  
 6 *and for, the periods presented in this quarterly report;*

7 \* \* \*

8 [The registrant's other certifying officers and I] *evaluated the effectiveness of the*  
 9 *registrant's disclosure controls and procedures as of a date within 90 days prior to*  
 10 *the filing date of this quarterly report (11/14/02); and... presented in this quarterly*  
 11 *report our conclusions about the effectiveness of the disclosure controls and*  
 12 *procedures based on our evaluation as of the Evaluation Date;*

13 \* \* \*

14 [The registrant's other certifying officers and I have disclosed] all significant  
 15 deficiencies in the design or operation of internal controls which could adversely  
 16 affect the registrant's ability to record, process, summarize and report financial data  
 17 and have identified for the registrant's auditors any material weaknesses in internal  
 18 controls; and b) any fraud, whether or not material, that involves management or  
 19 other employees who have a significant role in the registrant's internal controls...

20 193. The Company's 2004 Form 10-K also contained SOX Certifications signed by  
 21 defendants Richman and Chase and filed with the SEC. These Certifications stated, in part, *"the*  
 22 *information contained in the Report fairly presents, in all material respects, the financial*  
 23 *condition and results of operations of the Company at the dates and for the periods indicated."*

24 194. In addition to the foregoing, the 2004 Form 10-K also contained a report by Ernst &  
 25 Young, the Company's Independent Auditors that stated, in part, the following:

26 *We have audited the accompanying consolidated balance sheets of Terayon*  
 27 *Communication Systems, Inc. as of December 31, 2004 and 2003, and the related*  
 28 *consolidated statements of operations, stockholders' equity, and cash flows for*  
 29 *each of the three years in the period ended December 31, 2004....*

30 *We conducted our audits in accordance with the standards of the Public Company*  
 31 *Accounting Oversight Board (United States).... An audit also includes assessing*  
 32 *the accounting principles used and significant estimates made by management, as*  
 33 *well as evaluating the overall financial statement presentation. We believe that our*  
 34 *audits provide a reasonable basis for our opinion.*

35 *In our opinion, the consolidated financial statements referred to above present*  
 36 *fairly, in all material respects, the consolidated financial position of Terayon*  
 37 *Communication Systems, Inc. at December 31, 2004 and 2003, and the*  
 38 *consolidated results of its operations and its cash flows for each of the three years*



1 *in the period ended December 31, 2004, in conformity with U.S. generally accepted*  
 2 *accounting principles....*

3 We also have audited, in accordance with the standards of the Public Company  
 4 Accounting Oversight Board (United States), the effectiveness of Terayon  
 5 Communication Systems, Inc.'s internal control over financial reporting as of  
 6 December 31, 2004, based on criteria established in Internal Control — Integrated  
 7 Framework issued by the Committee of Sponsoring Organizations of the Treadway  
 8 Commission and *our report dated March 14, 2005 expressed an unqualified*  
*opinion on management's assessment and an adverse opinion on the effectiveness*  
*of internal control over financial reporting.*

9 \* \* \*

10 **Report of Independent Registered Public Accounting Firm on Internal Control over**  
 11 **Financial Reporting**

12 We have audited management's assessment, included in Management's Report on  
 13 Internal Control Over Financial Reporting in Item 9a, that Terayon Communication  
 14 Systems, Inc. ("Terayon") did not maintain effective internal control over financial  
 15 reporting as of December 31, 2004 because of the effect of the material weaknesses  
 16 described in management's assessment, based on criteria established in Internal  
 17 Control — Integrated Framework issued by the Committee of Sponsoring  
 18 Organizations of the Treadway Commission (the "COSO" criteria). Terayon's  
 19 management is responsible for maintaining effective internal control over financial  
 20 reporting and for its assessment of the effectiveness of internal control over financial  
 21 reporting. *Our responsibility is to express an opinion on management's assessment*  
 22 *and an opinion on the effectiveness of the company's internal control over*  
 23 *financial reporting based on our audit.*

24 We conducted our audit in accordance with the standards of the Public Company  
 25 Accounting Oversight Board (United States). *Those standards require that we plan*  
 26 *and perform the audit to obtain reasonable assurance about whether effective*  
 27 *internal control over financial reporting was maintained in all material respects.*  
 28 Our audit included obtaining an understanding of internal control over financial  
 reporting, evaluating management's assessment, testing and evaluating the design  
 and operating effectiveness of internal control, and performing such other procedures  
 as we considered necessary in the circumstances. *We believe that our audit provides*  
*a reasonable basis for our opinion.*

A company's internal control over financial reporting is a process designed to  
 provide reasonable assurance regarding the reliability of financial reporting and the  
 preparation of financial statements for external purposes in accordance with  
 generally accepted accounting principles. A company's internal control over financial  
 reporting includes those policies and procedures that (1) pertain to the maintenance  
 of records that, in reasonable detail, accurately and fairly reflect the transactions and  
 dispositions of the assets of the company; (2) provide reasonable assurance that  
 transactions are recorded as necessary to permit preparation of financial statements in  
 accordance with generally accepted accounting principles, and that receipts and  
 expenditures of the company are being made only in accordance with authorizations  
 of management and directors of the company; and (3) provide reasonable assurance  
 regarding prevention or timely detection of unauthorized acquisition, use, or

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1 disposition of the company's assets that could have a material effect on the financial  
2 statements.

3 \* \* \*

4 ***In our opinion, management's assessment that Terayon Communication Systems,***  
5 ***Inc. did not maintain effective internal control over financial reporting as of***  
6 ***December 31, 2004 is fairly stated, in all material respects, based on the COSO***  
7 ***control criteria.*** Also, in our opinion, because of the effect of the material  
weaknesses described above on the achievement of the objectives of the control  
criteria, Terayon Communication Systems, Inc. has not maintained effective internal  
control over financial reporting as of December 31, 2004, based on the COSO  
control criteria. [Emphasis added.]

8 195. The statements made by defendants and contained in Terayon's 2004 Form 10-K,  
9 were materially false and misleading and were known by defendants to be false at that time, or were  
10 recklessly disregarded as such, for the reasons stated herein in ¶ 64. In addition, the statements  
11 made by Ernst & Young and contained in the Company's 10-K were also materially false and  
12 misleading for, among other reasons, the following:

13 a. At all times during the Class Period, Terayon's financial statements and  
14 operational reports were *not* true accurate or reliable. In truth, Ernst & Young knew or recklessly  
15 disregarded that reported results, expenses, and cost accounting were materially false and  
16 misleading, and Terayon's, net income, earnings per share and shareholders equity had been  
17 materially overstated and its loss contingencies understated;

18 b. At all times during the relevant period, unbeknownst to investors, Ernst &  
19 Young had certified Terayon's financial statements as being GAAP compliant despite the fact that  
20 the Company's profitability was materially overstated and costs and expenses understated, as a  
21 result of defendants' failure to make proper and timely adjustments to Terayon's stated reports;

22 c. Throughout the Class Period, it was not true that Terayon contained adequate  
23 systems of internal operational or financial controls, such that the Company's financial results or  
24 operational reports were true, accurate or reliable. As investors ultimately learned, Terayon's  
25 internal financial accounting and disclosure controls were not adequate or effective and they had not  
26 been properly tested or retested by the Ernst & Young, so as to prevent material fraud in the  
27 presentation of the Company's financial results and condition; and  
28

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d. Terayon's internal control deficiencies were material and pervasive, and they had not been adequately corrected or overridden by management at any time during the Class Period. Accordingly, it was further false and misleading that Ernst & Young failed to respond to the Company's denials and omissions, made time after time, by the Individual Defendants, during the Class Period, as a means of explaining away the obvious material control deficiencies and procedural weaknesses.

May 3, 2005 Press Release and Conference Call Regarding "Record" 1Q:05 Results

196. On May 3, 2005, Terayon published a release announcing purported "record" setting results for the first quarter ended March 31, 2005. This release reported, in part, the following financial information about the Company:

**Digital Video Applications Revenue Grows to a Record \$13 Million for the Quarter, Increasing for the Fourth Consecutive Quarter**

\* \* \*

*Revenue for the first quarter of 2005 was \$26.4 million, a 10% decrease compared to \$29.4 million for the fourth quarter of 2004 and down 36% compared to \$41.2 million for the first quarter of 2004.*

\* \* \*

Net loss for the first quarter of 2005 narrowed to \$2.6 million, or \$0.03 per share, compared to a net loss of \$7.9 million, or \$0.10 per share, for the fourth quarter of 2004 and a net loss of \$10.2 million, or \$0.14 per share, for the first quarter of 2004.

197. This release also quoted defendants Chase and Richman, in part, as follows:

*"We are pleased with our first quarter results and our progress in moving digital video to the center of our corporate strategy," said Jerry Chase, Terayon Chief Executive Officer. "Our performance and momentum in digital video applications reflect the market's growing need for real-time video stream management as companies migrate to all-digital networks. As we maintain our focus on transitioning the company, our first quarter results confirm the market acceptance and unique position of Terayon's digital video solutions."*

\* \* \*

*"Our first quarter actions enhanced our market leadership in digital video and enabled us to better manage the costs of our home access products," Chase said. "CherryPicker's enabling technologies such as ad insertion and logo overlay, improve the ability for our customers to generate advertising revenues by increasing the competitiveness of digital video as a preferred method of branding, entertaining, communicating and informing."*



\* \* \*

*"Our focus and resources are clearly aligned to drive our strength—digital video networking applications—and we expect to continue to deliver top line growth that will achieve net income profits and positive cash flow,"* said Mark Richman, Terayon Chief Financial Officer. *"Our restructuring activities and increased focus on operational cost management in 2005 support this drive to net income."* [Emphasis added.]

198. Later the same day, on May 3, 2005, defendants also conducted a conference call for analysts and investors, hosted by defendants Richman and Chase. During this call, defendant Chase stated, in part, the following:

**JERRY CHASE, CEO, TERAYON COMMUNICATION SYSTEMS:** Thanks, Mark. Hello, everyone, and thank you for joining us for Terayon's Q1 2005 earnings conference call. *As you can see from our earnings press release issued earlier today, Terayon had a good first quarter, showing notable progress in moving digital video to the center of our corporate strategy. In addition, we took important steps toward sustainable profitability.* Let's begin our update with digital video applications.

\* \* \*

*While there is much work to be done, we are pleased with our progress during the first quarter.* A strong second quarter pipeline indicates continued growth as we remain focused on driving to sustainable profits and positive cash flow. To do this, we will continue to invest in digital video, to strengthen our current cable market leadership position, and grow across associated vertical markets like satellite, broadcast and Telco. We'll build on our market-leading digital video applications, particularly in the area of advertising. We'll expand our strong video partner program to integrate our solutions into new types of video systems and markets, and we'll manage our home access business to re-establish profitable growth and cash contributions. *By executing on these objectives, we expect to continue healthy improvements.* [Emphasis added.]

199. During this call, defendant Richman also stated, in part, the following:

**MARK RICHMAN:** Thank you, Jerry. *I am very pleased to announce that we have met or exceeded all previously-announced financial guidance for the first quarter of 2005. We report net revenues of \$26.4 million down from \$29.4 million in the fourth quarter of 2004.* Most importantly, we grew our digital video revenue in the first quarter of 2005 to our record \$13 million, despite capital expenditure patterns that often experience reduced Q4 to Q1 CapEx activity. In addition, we launched the 7600G, and while we did not ship or record revenues in the first quarter, demand for the 7600G should support continued revenue growth beginning in the second quarter 2005.

///

///

///

\* \* \*

*Our net loss in the first quarter of 2005 was \$2.6 million or \$0.03 per share, compared to \$7.9 million or \$0.10 per share in the fourth quarter of 2004.* Excluding the previously mentioned benefits of a reversal of warranty reserves and bad debt recoveries, we would have recorded a net loss of approximately \$3.7 million or \$0.05 a share, which we believe is a better indicator of our current period performance. *This still compares favorably to our previously-announced guidance of a loss from \$3 to \$6 million.* [Emphasis added.]

200. As a direct result of the statements made or published by defendants, the following day, May 4, 2005, *MarketWatch.com* reported that Terayon shares soared. According to this report, shares of Terayon rose 17%, to \$3.22 per share, in afternoon trading Wednesday after the Company posted overnight a narrower-than-expected first-quarter loss. The perceived improvement in its performance prompted brokerage Merriman Curhan Ford & Co. to upgrade the Company to "Buy" from "Neutral," citing optimism over the value, growth and earnings power of its digital video unit. The Thomson First Call average estimate was for a loss of four cents a share on revenues of \$27.9 million.

10-Q for First Quarter 2005

201. On or about May 10, 2005, defendants filed with the SEC the Company's Form 10-Q for the quarter ended March 31, 2005 ("1Q:05 Form 10-Q"), signed by defendant Richman and certified by defendants Richman and Case. In addition to making substantially similar statements concerning the Company's procedures and its financial operations as had been made by defendants previously, the 1Q:05 Form 10-Q also stated, in part, the following:

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X.... *In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the condensed consolidated financial statements at March 31, 2005 and for the three months ended March 31, 2005 and 2004 have been included.* [Emphasis added.]

202. The Company's 1Q:05 Form 10-Q also reported Terayon's Liquidity and Capital Resources, in part, as follows:

At March 31, 2005, we had approximately \$30.6 million in unrestricted cash and cash equivalents and \$69.2 million in short-term investments.

1 ***In July 2000, we issued \$500.0 million of Notes, resulting in net proceeds to us of***  
2 ***approximately \$484.4 million. The Notes are a general unsecured obligation and***  
3 ***are subordinated in right of payment to all of our existing and future senior***  
4 ***indebtedness and to all of the liabilities of our subsidiaries.*** The Notes are  
5 convertible into shares of our common stock at a conversion price of \$84.01 per  
share at any time on or after October 24, 2000 through maturity, unless previously  
redeemed or repurchased. Interest is payable semi-annually. ***Debt issuance costs***  
***related to the Notes were approximately \$15.6 million.*** The Notes mature in August  
2007.

6 Through March 31, 2005, we had repurchased approximately \$434.9 million of the  
7 Notes for \$171.0 million in cash and \$17.9 million in stock, resulting in a gain on  
early retirement of debt of approximately \$234.4 million net of related unamortized  
8 issuance costs of \$11.6 million in prior periods. No Notes were repurchased in 2003,  
2004, or 2005. [Emphasis added.]

9 203. In addition to the foregoing, the Company's 1Q:05 Form 10-Q also contained  
10 statements that attested to the purported sufficiency of Terayon's controls and procedures. While  
11 the 1Q:05 Form 10-Q did again acknowledge certain defects in the Company's communications  
12 protocols, the 1Q:05 Form 10-Q also reported that these problems had been substantially resolved  
13 and that, following a review of the Board of Directors, the Company's internal controls and  
14 procedures were reasonably adequate. As evidence of this, the 1Q:05 Form 10-Q also stated, in  
15 part, the following:

16 Under the supervision and with the participation of our senior management,  
17 including our CEO and CFO, we conducted an evaluation of the effectiveness of the  
design and operation of our disclosure controls and procedures as of March 31, 2005.  
18 ***Based on that evaluation, as of the date of the evaluation, our management,***  
***including our CEO and CFO, concluded that our disclosure controls and***  
19 ***procedures were not effective as of March 31, 2005 because of the material***  
***weakness described below. We have already implemented, and will continue to***  
20 ***implement, corrective actions with respect to this material weakness, as further***  
***described below.***

21 \* \* \*

22 As part of the evaluation of our disclosure controls and procedures as of March 31,  
23 2005, we determined that we have remediated the material weakness related to our  
procedures and controls over the preparation and review of our consolidated financial  
24 statements and accompanying footnote disclosures contained in this Quarterly Report  
on Form 10-Q. ***The insufficient controls, which were originally identified during***  
***the preparation of the Annual Report on Form 10-K, included a lack of sufficient***  
25 ***personnel with technical accounting expertise in our finance department and***  
***inadequate review and approval procedures to prepare external financial***  
26 ***statements in accordance with GAAP. As a result of the new procedures and***  
***controls we implemented for the preparation and review of this Quarterly Report***  
27 ***on Form 10-Q and the remediation steps described below, we believe we have***  
28



1 remediated this material weakness. Senior management will continue to monitor the  
2 technical accounting expertise of finance personnel staff closely to ensure that  
adequate review and approval of our financial statements is maintained.

3  
4 As part of the same evaluation, we determined, however, that we have not completed  
5 implementation of the changes we believe are required to remediate the previously  
6 reported material weakness related to the inadequacy of communication between our  
7 senior management and the finance department. During their review of our interim  
8 financial results for the three months ended March 31, 2005, our independent  
9 registered public accounting firm identified two significant adjustments to our  
financial statements as part of their quarterly review procedures. These two  
adjustments were the result of the continued lack of communication within the  
Company with regards to certain severance obligations and our policy for the  
allowance for doubtful accounts. *These two adjustments were corrected prior to the*  
10 *issuance of our financial statement for the three months ended March 31, 2005.*  
11 [Emphasis added.]

12 204. In addition to the foregoing, the 1Q:05 Form 10-Q also contained a series of  
13 statements that purported to attest to the fact that the Company had *already* remediated the control  
14 weaknesses and other problems that were then adversely impacting the Company, including that:

#### 15 Remediation Steps

16 During the quarter ended March 31, 2005 and through to the date of the filing of this  
17 Form 10-Q, and in response to the material weaknesses identified as of December 31,  
18 2004, we implemented the following steps to remediate the deficiencies in our  
19 disclosure controls and procedures and material weaknesses in our internal control  
20 over financial reporting.

21 (i) Established procedures to document the review of press releases to  
22 account for transactions in a complete and timely manner;

23 (ii) Engaged the former Assistant Controller, who has significant SEC  
24 reporting experience, to serve as our Controller, in part to supervise our financial  
25 reporting to ensure compliance with SEC requirements;

26 (iii) Promoted our Consolidations Reporting Manager to Director of  
27 Accounting to provide greater individual management of all accounting functions;  
28 and

(iv) Improved our internal process of drafting and reviewing periodic reports  
by implementing additional management and external legal counsel review prior to  
their submission to our independent registered public accounting firm.

Moreover, we intend to implement the following additional remediation steps to  
address the material weakness related to the inadequacy of communication between  
our senior management and the finance department;

1 (i) Continue to monitor the communication channels between our senior  
2 management and our finance department and take prompt action, as necessary, to  
further strengthen these communication channels;

3 (ii) Increase staffing in the finance department;

4 (iii) Re-allocate duties to persons within the finance organization to  
5 maximize their skills and experience;

6 (iv) Implement training procedures for new employees and/or consultants in  
the finance department on our disclosure procedures and controls, our Company and  
7 our actions in previous reporting periods; and

8 (v) Take steps to ensure that our senior management has timely access to all  
material financial and non-financial information concerning our business.

9 **Changes in internal control over financial reporting.**

10 *Other than as described above, there has been no change in our internal control*  
11 *over financial reporting during our most recently completed fiscal quarter* that has  
materially affected or is likely to materially affect our internal control over financial  
12 reporting. [Emphasis added.]

13 205. Again, the statements concerning the Company's controls and procedures was also  
14 critically important to investors as a result of the related-party nature of a material amount of the  
15 Company's revenues. Accordingly, the Company's 1Q:05 Form 10-Q described these related party  
16 transactions, in part, as follows:

17 **Related Party Transactions**

18 Lewis Solomon, a member of the Company's Board of Directors is also a member of  
the Board of Directors of Harmonic, Inc. (Harmonic). Harmonic is an authorized,  
19 non-exclusive reseller of certain of the Company's video products. For the three  
months ended March 31, 2005 and March 31, 2004, related party revenue from  
20 Harmonic was \$8.8 million and \$0.7 million, respectively.

21 Cost of related party revenues in the Company's consolidated statements of  
operations consists of direct and indirect costs. Accounts receivable from Harmonic  
22 totaled approximately \$6.4 million at March 31, 2005. Harmonic is not a supplier to  
the Company.  
23

24 *SOX Certifications for 1Q:05 Form 10-Q*

25 206. The 1Q:05 Form 10-Q also contained SOX signed by defendants Chase and Richman  
26 and filed with the SEC. These Certifications stated, in part, "*the information contained in the*  
27 *Report fairly presents, in all material respects, the financial condition and results of operations*  
28 *of the Company at the dates and for the periods indicated.*" [Emphasis added.]

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207. The statements made by defendants and contained in the Company's May 3, 2005 press release, those statements made by defendants during the quarterly conference call, and those statements contained in Terayon's 1Q:05 Form 10-Q, were each materially false and misleading and were known by defendants to be false at that time, or were recklessly disregarded as such, for the reasons stated herein in ¶ 64.

July 28, 2005 Release and Conference Call Announcing Results for 2Q:05

208. On July 28, 2005, Terayon published a release announcing results for the second quarter ended June 30, 2005 – the fifth purported consecutive quarter of increasing revenues. This release reported quarterly financial information about the Company, in part, as follows:

**Terayon Reports Second Quarter 2005 Results; Digital Video Applications Revenue Grows to a Record \$17.3 Million for the Quarter, Increasing for the Fifth Consecutive Quarter**

*Revenue for the second quarter of 2005 was \$29.5 million, a 12% increase compared to \$26.4 million for the first quarter of 2005 and down 31% compared to \$42.8 million for the second quarter of 2004.*

\* \* \*

*Net loss for the second quarter of 2005 was \$508,000, or \$0.01 per share, compared to a net loss of \$2.6 million, or \$0.03 per share, for the first quarter of 2005 and a net loss of \$4.9 million, or \$0.06 per share, for the second quarter of 2004.*

209. Commenting on the purported strength and financial operations of the Company, the July 28, 2005 release also quoted defendants Chase and Richman, in part, as follows:

*"Second quarter results indicate solid progress in moving digital video to the center of our corporate strategy," said Jerry Chase, Terayon Chief Executive Officer. "The second quarter marks the fifth consecutive quarter of record revenue for our digital video solutions. We believe this is due to Terayon's unique ability to address fundamental changes occurring in the market."*

\* \* \*

*"Our digital video revenue growth coupled with reduced operating expenses positions us closer to our goal of profitability," said Mark Richman, Terayon Chief Financial Officer. "Our focus remains on execution to drive revenues and asset and expense management to drive net income profitability." [Emphasis added.]*

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210. Later the same day, defendants also conducted a conference call for analysts and investors, hosted by defendants Richman and Chase. During this call, defendant Chase stated, in part, the following:

**JERRY CHASE, CEO, TERAYON COMMUNICATION SYSTEMS:** Thank you, Mark, and hello everyone. Thank you for joining us for the call. Earlier this afternoon, we released our second quarter results. I am pleased with the ongoing progress we are making towards executing on a unique market position that is driving us towards profitability. We are fortunate that market factors continue to trend in our direction. We have become a solid player in real time digital video networking applications and our product quality across our video and home access product lines remain high. *Terayon has achieved a number of milestones this past quarter, including video revenues were up for the fifth straight quarter to 17.3 million, giving us the best video quarter we've ever had. We are cash flow positive for the second consecutive quarter, indicative of an increased focus on asset and expense management, and customer diversification continues to improve each quarter.*

\* \* \*

With the market trends moving toward what we do best, coupled with a steady focus on strengthening customer relationships, broadening customer diversity, delivering new product innovations and building a stronger partner channel, *Terayon has made steady and solid progress against our digital video goals this past quarter.*

\* \* \*

*The second quarter has been a good one for us and we are confident in our ability to continue this progress.* Market trends continue to shift toward what Terayon does best and we are in a great position to capture the opportunity. The initial phase of Comcast digital simulcast projects has generated not only sales but also strengthened our relationship with them. We are winning new customers and expanding our business within our current base. We expect all these trends will continue over the long run as the job of building revenue producing all digital networks is at the beginning of the cycle. We do expect a small fall-off in demand in the third quarter as our customers absorb what they have bought and now must implement. This is a timing issue, not a demand issue. We expect orders from Comcast to be lower in the third quarter. However, it will be offset slightly through sales to other MSOs which also diversify their customer base. *We are winning market share and expect that trend to continue in the third quarter despite the projected small decline in revenue.*

\* \* \*

**JERRY CHASE:** Thank you, Mark. *Our second quarter results certainly indicate the effectiveness of our plan and execution to date. I am optimistic about our ability to maintain its focus and deliver favorably against our business plan.* Our customers have honored us by making us a vendor in high standing and our products earned high marks for their excellent performance in quality. While there's always more to be done, Mark and I look forward to providing you with updates on our progress as we continue to transition Terayon to a digital video company. [Emphasis added.]

211. During this call, defendant Richman also stated, in part, the following:

**MARK RICHMAN:** Thank you, Jerry. *I am very pleased to announce that we have met or exceeded all previously announced financial guidance for the second quarter of 2005 and reporting second quarter revenues of 29.5 million, we have returned to top line growth, up from 26.4 million in the first quarter of 2005. Most importantly, we grew our digital video revenue in the second quarter of 2005 to a record 17.3 million, up from 13 million in the first quarter.* This growth was in large part attributable to market acceptance of our CP 7600G edge decoder that contributed 6.6 million of revenues in Q2. The CP 7600G revenue contribution exceeded expectations reflecting the growing trend of building out all digital networks.

\* \* \*

*Our net loss in the second quarter was near break-even at half a million dollars, or \$0.01 per share compared to a loss of 2.6 million or \$0.03 per share in the first quarter of 2005.*

\* \* \*

As a final comment and as we will shortly announce in an SEC 8-K filing, *we were recently advised by Ernst and Young that it resigned as the Company's independent registered public accounting firm effective upon the completion of services related to the review of the Company's interim financial statements for the quarter ending September 30th, 2004. While we consider this development to be unfortunate, we understand that Terayon and other companies are losing the services of a Big 4 accounting firm.* We are immediately working to resolve this issue and our audit committee and management have commenced the search for a new, independent registered public accountant. *This development will not impact our market opportunities and will not diminish the confidence and optimism that we have with regard to our business prospects. I would like to thank you for listening and will now turn the call back to Jerry.* [Emphasis added.]

212. The statements made in the July 28, 2005 release and conference call were false and misleading for the reasons set forth at ¶ 64. The statement in the conference call that "Terayon and other companies are losing the services of a Big 4 accounting firm" is also false and misleading because it implies that the reason for the departure of Ernst & Young is not related to Terayon's massive accounting irregularities, GAAP violations, and the like, but rather simply stems from the fact that the "Big 4" cannot service Terayon and other companies.

August 1, 2005 8-K Regarding Sudden Resignation of Ernst & Young

213. On August 1, 2005, defendants filed with the SEC pursuant to Form 8-K, a report announcing that Terayon had retained a new Independent Auditor. Of critical importance to investors, at that time, this report stated that the *selection of its new auditors did not result from*

1 *any disagreement or problem with its prior auditors, Ernst & Young.* The Company's August 1,  
2 2005 form 8-K, signed by Defendant Richman, stated, in substantial part, the following:

3 **Item 4.01. Changes in Registrant's Certifying Accountant.**

4 On July 26, 2005, Terayon Communication Systems, Inc. (the "Company"), was  
5 advised by Ernst & Young LLP ("Ernst & Young") that Ernst & Young will resign as  
6 the Company's independent registered public accounting firm following the earlier of  
7 the completion of services related to the review of the Company's interim financial  
8 statements for the quarter ending September 30, 2005 or the filing due date of that  
9 quarterly report.

10 *The reports of Ernst & Young on the Company's financial statements as of and*  
11 *for the years ended December 31, 2004 and 2003 did not contain an adverse*  
12 *opinion or a disclaimer of opinion and were not qualified or modified as to*  
13 *uncertainty, audit scope, or accounting principles.*

14 *In connection with the audits of the Company's most recent two years ended*  
15 *December 31, 2004 and 2003 and in the subsequent interim period, there were no*  
16 *disagreements (as described under Item 304(a)(1)(iv) of Regulation S-K) between*  
17 *Ernst & Young and the Company on any matter of accounting principles or*  
18 *practices, financial statement disclosure, or auditing scope and procedures, that, if*  
19 *not resolved to the satisfaction of Ernst & Young, would have caused Ernst &*  
20 *Young to make reference to the subject matter of the disagreement in connection*  
21 *with its reports on the Company's financial statements for such years.*

22 *During the years ended December 31, 2004 and 2003, and through July 26, 2005,*  
23 *there were no "reportable events" as described in Item 304(a)(1)(v) of Regulation*  
24 *S-K, other than the two material weaknesses disclosed in the Company's Form 10-*  
25 *K filed on March 15, 2005 and as described below:*

26 First, management identified a material weakness due to insufficient controls related  
27 to the identification, capture, and timely communication of financially significant  
28 information between certain parts of the organization and the finance department to  
enable the finance department to account for transactions in a complete and timely  
manner. As a result of this material weakness, management recorded an adjustment  
in the quarter ended September 30, 2004 to record termination benefits paid to a  
former executive.

Second, management also identified a material weakness for insufficient controls  
related to the preparation and review of the annual consolidated financial statements  
and accompanying footnote disclosures. The insufficient controls include a lack of  
sufficient personnel with technical accounting expertise in the finance department  
and inadequate review and approval procedures to prepare external financial  
statements in accordance with generally accepted accounting principles (GAAP). As  
a result of this material weakness, management made substantial revisions to its 2004  
annual consolidated financial statements and footnote disclosures before they were  
issued.



*Ernst & Young did not seek the Company's consent to its resignation. As a result, the Company's audit committee did not recommend or approve the resignation of Ernst & Young.*

The Company has provided Ernst & Young with a copy of the foregoing disclosures and requested that Ernst & Young furnish a letter to the Securities and Exchange Commission stating whether or not Ernst & Young agrees with the above statements. Ernst & Young furnished such a letter, dated August 1, 2005, a copy of which is attached hereto as Exhibit 16.1.

The Company's audit committee has commenced the process of selecting an independent registered public accounting firm to replace Ernst & Young. [Emphasis added.]

214. Also attached to the Company's September 28, 2005 Form 8-K was an August 1, 2005 letter from Ernst & Young to the SEC (Office of Chief Accountant), that stated the following:

*We have read Item 4.01 of Form 8-K dated July 26, 2005, of Terayon Communication Systems, Inc. and are in agreement with the statements contained in paragraphs 1 through 6 and the first sentence of paragraph 7 on page 2 therein. We have no basis to agree or disagree with other statements of the registrant contained therein.*

*Regarding the registrant's statements concerning the lack of internal control to prepare financial statements, included in paragraphs 4 through 6 on page 2 therein, we had considered such matters in determining the nature, timing and extent of procedures performed in our audit of the registrant's 2004 financial statements.* [Emphasis added.]

Form 10-Q for Second Quarter 2005

215. On or about August 9, 2005, defendants filed with the SEC the Company's Form 10-Q for the quarter ended June 30, 2005 ("2Q:05 Form 10-Q"), signed by defendant Richman and certified by defendants Richman and Case. In addition to making substantially similar statements concerning the Company operations and its financial operations as had been made by defendants previously, the 2Q:05 Form 10-Q also stated, in part, the following:

**2. Summary of Significant Accounting Policies**

**Basis of Presentation**

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X.... *In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of*

1 *the condensed consolidated financial statements at June 30, 2005 and for the three*  
 2 *and six months ended June 30, 2005 and 2004 have been included.* [Emphasis

3 216. The Company's 2Q:05 Form 10-Q also reported Terayon's Liquidity and Capital  
 4 Resources, in part, as follows:

5 At June 30, 2005, we had approximately \$38.6 million in unrestricted cash and cash  
 6 equivalents and \$66.4 million in short-term investments.

7 *In July 2000, we issued \$500.0 million of Notes, resulting in net proceeds to us of*  
 8 *approximately \$484.4 million.* The Notes are a general unsecured obligation and are  
 9 subordinated in right of payment to all of our existing and future senior indebtedness  
 10 and to all of the liabilities of our subsidiaries. The Notes are convertible into shares  
 11 of our common stock at a conversion price of \$84.01 per share at any time on or after  
 12 October 24, 2000 through maturity, unless previously redeemed or repurchased.  
 13 Interest is payable semi-annually. *Debt issuance costs related to the Notes were*  
 14 *approximately \$15.6 million.* The Notes mature in August 2007.

15 *Through June 30, 2005, we had repurchased approximately \$434.9 million of the*  
 16 *Notes for \$171.0 million in cash and \$17.9 million in stock, resulting in a gain on*  
 17 *early retirement of debt of approximately \$234.4 million* net of related unamortized  
 18 issuance costs of \$11.6 million in prior periods. No Notes were repurchased in 2003,  
 19 2004, or 2005. [Emphasis added.]

20 217. The Company's 1Q:05 Form 10-Q also contained statements that attested to the  
 21 purported adequacy of Terayon's controls and procedures. While the 1Q:05 Form 10-Q did  
 22 acknowledge certain minor defects in its communications protocols, the 1Q:05 Form 10-Q also  
 23 reported that these problems had been substantially remedied and that, following a review of the  
 24 Board of Directors, the Company's internal controls and procedures continued to be reasonably  
 25 adequate. As evidence of this, the 1Q:05 Form 10-Q also stated, in part, the following:

26 *Under the supervision and with the participation of our senior management,*  
 27 *including our CEO and CFO, we conducted an evaluation of the effectiveness of*  
 28 *the design and operation of our disclosure controls and procedures as of June 30,*  
 29 *2005. Based on that evaluation, as of the date of the evaluation, our management,*  
 30 *including our CEO and CFO, concluded that our disclosure controls and*  
 31 *procedures were effective as of June 30, 2005.*

32 \* \* \*

33 *As part of the evaluation of our disclosure controls and procedures as of June 30,*  
 34 *2005, we determined that we have remediated the material weakness related to our*  
 35 *procedures and controls over the preparation and review of our consolidated*  
 36 *financial statements and accompanying footnote disclosures contained in this*  
 37 *Quarterly Report on Form 10-Q.* The insufficient controls, which were originally  
 38 identified during the preparation of the Annual Report on Form 10-K, included a lack  
 of sufficient personnel with technical accounting expertise in our finance department  
 and inadequate review and approval procedures to prepare external financial

1 statements in accordance with GAAP. *As a result of the new procedures and*  
2 *controls we implemented for the preparation and review of this Quarterly Report*  
3 *on Form 10-Q and the remediation steps described below, we believe we have*  
4 *remediated this material weakness.* Senior management will continue to monitor the  
technical accounting expertise of finance personnel staff closely to ensure that  
adequate review and approval of our financial statements is maintained.

5 During their review of our interim financial results for the three months ended March  
6 31, 2005, our independent registered public accounting firm identified two  
7 significant adjustments to our financial statements as part of their quarterly review  
8 procedures. These two adjustments were the result of the continued lack of  
9 communication within the Company with regards to certain severance obligations  
10 and our policy for the allowance for doubtful accounts. These two adjustments were  
11 corrected prior to the issuance of our financial statements for the three months ended  
12 March 31, 2005. *As part of an evaluation we conducted at June 30, 2005, we*  
13 *determined, however, that we have completed implementation of the changes we*  
14 *believe are required to remediate the previously reported material weakness related*  
15 *to the inadequacy of communication between our senior management and the*  
16 *finance department, which caused these two adjustments.*

#### 17 Remediation Steps

18 During the quarter ended June 30, 2005 and through to the date of the filing of this  
19 Form 10-Q, and in response to the material weaknesses identified as of December 31,  
20 2004 and March 31, 2005, we implemented the following steps to remediate the  
21 deficiencies in our disclosure controls and procedures and material weaknesses in our  
22 internal control over financial reporting.

23 (i) Established procedures to document the review of press releases to  
24 account for transactions in a complete and timely manner;

25 (ii) Engaged the former Assistant Controller, who has significant SEC  
26 reporting experience, to serve as our Controller, in part to supervise our financial  
27 reporting to ensure compliance with SEC requirements;

28 (iii) Promoted our Consolidations Reporting Manager to Director of  
Accounting to provide greater individual management of all accounting functions;  
and

(iv) Improved our internal process of drafting and reviewing periodic  
reports by implementing additional management and external legal counsel review  
prior to their submission to our independent registered public accounting firm.

Moreover, we implemented the following additional remediation steps to address the  
material weakness related to the inadequacy of communication between our senior  
management and the finance department;

(i) Continue to monitor the communication channels between our senior  
management and our finance department and take prompt action, as necessary, to  
further strengthen these communication channels;



- 1 (ii) Increase staffing in the finance department;
- 2 (iii) Re-allocate duties to persons within the finance organization to
- 3 maximize their skills and experience;
- 4 (iv) Implement training procedures for new employees and/or consultants
- 5 in the finance department on our disclosure procedures and controls, our Company
- 6 and our actions in previous reporting periods; and
- 7 (v) Take steps to ensure that our senior management has timely access to
- 8 all material financial and non-financial information concerning our business.

Changes in internal control over financial reporting. Other than as described above, there has been no change in our internal control over financial reporting during our most recently completed fiscal quarter that has materially affected or is likely to materially affect our internal control over financial reporting. [Emphasis added.]

218. Again the statements concerning the Company's controls and procedures were of critical important to investors, as a result of the related-party nature of a material amount of the Company's revenues. Accordingly, the Company's 1Q:05 Form 10-Q again described these related party transactions, in part, as follows:

#### 14 Related Party Transactions

15 Lewis Solomon, a member of the Company's Board of Directors is also a member of  
16 the Board of Directors of Harmonic, Inc. (Harmonic). Harmonic is an authorized,  
17 non-exclusive reseller of certain of the Company's video products. For the six  
18 months ended June 30, 2005 and June 30, 2004, related party revenue from  
19 Harmonic was \$13.7 million and \$3.4 million, respectively.

20 Cost of related party revenues in the Company's consolidated statements of  
21 operations consists of direct and indirect costs. Accounts receivable from Harmonic  
22 totaled approximately \$2.3 million at June 30, 2005. Harmonic is not a supplier to  
23 the Company.

#### 21 SOX Certifications for Form 10-Q for First Quarter 2005

22 219. The 1Q:05 Form 10-Q also contained SOX Certifications signed by defendants  
23 Chase and Richman, and filed with the SEC. These Certifications stated, in part "*the information*  
24 *contained in the Report fairly presents, in all material respects, the financial condition and*  
25 *results of operations of the Company at the dates and for the periods indicated.*" [Emphasis  
26 added.]

220. The statements made by defendants contained in Terayon's 2Q:05 Form 10-Q and its August 1, 2005 Form 8-K, were each materially false and misleading and were known by defendants to be false at that time, or were recklessly disregarded as such, for the reasons stated herein in ¶ 64.

September 27, 2005 8-K re: Change of Independent Auditor

221. On September 27, 2005, defendants filed with the SEC pursuant to Form 8-K, in part, the following statement regarding the change of Terayon's independent auditors:

**Item 4.01. Changes in Registrant's Certifying Accountant.**

(a) As previously disclosed by Terayon Communication Systems, Inc. (the "Company") in its Current Report on Form 8-K filed on August 1, 2005, the Company's former independent registered public accounting firm, Ernst & Young LLP, ("Ernst & Young") informed the Company that it would resign as the Company's independent registered public accounting firm effective upon the earlier of completion of services related to the review of the Company's interim financial statements for the quarter ending September 30, 2005 or the filing due date of that quarterly report. Ernst & Young did not seek the Company's consent to its resignation. As a result, the Company's Audit Committee did not recommend or approve the resignation of Ernst & Young.

On August 9, 2005, the Company filed its Quarterly Report on Form 10-Q for the quarter ended June 30, 2005. Ernst & Young served as the Company's independent registered public accounting firm in reviewing the Company's interim financial statements for the quarter ended June 30, 2005 for purposes of that quarterly report.

On September 21, 2005, the Audit Committee of the Board of Directors of the Company engaged Stonefield Josephson, Inc. ("Stonefield Josephson") as the Company's new independent registered public accounting firm to audit the Company's financial statements for the fiscal year ended December 31, 2005, and to perform certain procedures related to the financial statements to be included in the Company's quarterly reports on Form 10-Q. Effective as of such date, Ernst & Young resigned as the Company's independent registered public accounting firm.

The reports of Ernst & Young on the Company's financial statements as of and for the years ended December 31, 2004 and 2003 did not contain an adverse opinion or a disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope, or accounting principles.

In connection with the audits of the Company's most recent two years ended December 31, 2004 and 2003 and in the subsequent interim periods, there were no disagreements (as described under Item 304(a)(1)(iv) of Regulation S-K) between Ernst & Young and the Company on any matter of accounting principles or practices, financial statement disclosure, or auditing scope and procedures, that, if not resolved to the satisfaction of Ernst & Young, would have caused Ernst & Young to make reference to the subject matter of the disagreement in connection with its reports on the Company's financial statements for such years.

1 *During the years ended December 31, 2004 and 2003, and through September 21,*  
 2 *2005, there were no "reportable events" as described in Item 304(a)(1)(v) of*  
 3 *Regulation S-K, other than the two material weaknesses disclosed in the*  
*Company's Annual Report on Form 10-K filed on March 15, 2005 and as described*  
 below:

4 \* \* \*

5 *The Company has provided Ernst & Young with a copy of the foregoing*  
 6 *disclosures and requested that Ernst & Young furnish a letter to the Securities and*  
 7 *Exchange Commission stating whether or not Ernst & Young agrees with the above*  
*statements. Ernst & Young furnished such a letter, dated September 23, 2005, a copy*  
 of which is attached hereto as Exhibit 16.1.

8 (b) On September 21, 2005, the Audit Committee of the Board of  
 9 Directors of the Company engaged Stonefield Josephson as the Company's new  
 10 independent registered public accounting firm to audit the Company's financial  
 11 statements for the fiscal year ended December 31, 2005, and to perform certain  
 12 procedures related to the financial statements to be included in the Company's  
 13 quarterly reports on Form 10-Q. The Company did not consult Stonefield Josephson  
 on any matter or event described in Item 304(a)(2)(i) or (ii) of Regulation S-K during  
 the Company's two most recent fiscal years and through September 21, 2005, the  
 effective date of the Company's engagement of Stonefield Josephson. [Emphasis  
 added.]

14 222. Also attached to the Company's September 28, 2005 Form 8-K was a September 23,  
 15 2005 letter from Ernst & Young to the SEC, that stated, in relevant part:

16 We have read Item 4.01 of Form 8-K dated September 21, 2005, of Terayon  
 17 Communication Systems, Inc. and are in agreement with the statements contained in  
 18 the first and second sentences of paragraph 1, the second sentence of paragraphs 2  
 and 3, and paragraphs 4 through 8 on page 2 therein. *We have no basis to agree or*  
*disagree with other statements of the registrant contained therein.*

19 *Regarding the registrant's statements concerning the lack of internal control to*  
 20 *prepare financial statements, included in paragraphs 6 through 8 on page 2*  
 21 *therein, we had considered such matters in determining the nature, timing and*  
*extent of procedures performed in our audit of the registrant's 2004 financial*  
*statements.* [Emphasis added.]

22 September 30, 2005 Release re: Change in Independent Auditor

23 223. On September 30, 2005, defendants published a release announcing that Terayon had  
 24 retained a new independent auditor. This release stated that its new auditors were an "excellent fit,"  
 25 and again defendants implied that this change was *not the result of any disagreement or problem*  
 26 *with its prior auditors, Ernst & Young.* Accordingly, as evidence of this, the Company's  
 27 September 30, 2005 release stated, in substantial part, the following:



**Terayon Signs New Independent Auditor**

Terayon Communication Systems, Inc. (NASDAQ:TERN), a leading provider of digital video networking applications and home access solutions, today announced that it engaged Stonefield Josephson, Inc., a Santa Monica-based accounting firm with Bay Area offices, as the company's new independent auditor effective September 21, 2005.

"Through our extensive search for an external audit firm with strong SEC experience, we identified and signed Stonefield Josephson, which precisely meets our auditing requirements," said Mark Richman, Terayon Chief Financial Officer. "Their full range of audit services and Sarbanes-Oxley experience make them an excellent fit for Terayon."

Stonefield Josephson will immediately take over responsibilities as the external auditor beginning with the review of the Company's third quarter fiscal calendar.

224. The statements made by defendants and contained in the Company's September 30, 2005 press release, those statements made by defendants during the investor conferences, and those statements contained in Terayon's Form 8-K, referenced above, were each materially false and misleading and were known by defendants to be false at that time, or were recklessly disregarded as such, for the reasons stated herein in ¶ 64.

**DEFENDANTS CONTINUE TO MAKE FALSE AND MISLEADING STATEMENTS  
EVEN AFTER THE TRUTH SLOWLY BEGINS TO EMERGE**

225. Only weeks after Terayon replaced its auditors, on November 7, 2005, defendants published a release announcing that the Company would delay the announcement and filing of its third quarter financial results. At the same time, defendants also announced that certain revenues from "a customer" *may have been recognized improperly and in violation of the Company's stated revenue recognition policies.*

226. In this regard, the Company's November 7, 2005 release stated, in part, the following:

**Terayon Announces Accounting Review and Delay in Release of Third Quarter 2005 Results**

Terayon Communication Systems, Inc. (NASDAQ:TERN), a leading provider of digital video networking applications and home access solutions, *today announced that it is reviewing the recognition of revenue for certain transactions during prior periods. Terayon initiated the review after determining that certain revenues recognized in the second half of fiscal year 2004 from a customer may have been*

1 *recorded in incorrect periods. The revenue matters under examination relate to the*  
2 *timing of revenue recognition and may result in a restatement of prior period*  
3 *financials.*

4 Pending completion of the accounting review, the filing of Terayon's Form 10-Q for  
5 the third quarter of fiscal year 2005 will be delayed, and this delay will extend  
6 beyond the Form 10-Q's filing deadline of November 9, 2005. Terayon also will  
7 delay the filing of its third quarter 2005 earnings release and conference call,  
8 originally scheduled for November 8, 2005.

9 *The accounting review includes an examination of whether a restatement of prior*  
10 *period financial statements may be required as it relates to the customer*  
11 *transactions in question, in addition to an examination of Terayon's revenue*  
12 *recognition policies and practices for current and past periods and an examination*  
13 *of Terayon's internal control over financial reporting as it relates to these items.*  
14 There can be no assurance that Terayon or its independent auditors will not identify  
15 additional issues or other considerations in connection with the current review, and  
16 that these issues or considerations will not require further adjustments to the  
17 company's prior financial results for one or more prior fiscal years or quarters.

18 *"We are committed to accurate and transparent financial reporting and are taking*  
19 *this matter very seriously," said Jerry Chase, CEO, Terayon. "I want to emphasize*  
20 *that our cash position and market leadership remain strong and are not affected*  
21 *by the accounting issues under review. We remain focused on executing on our*  
22 *strategies and continuing to expand our product innovations to strengthen the overall*  
23 *position of the company."*

24 Terayon and the Audit Committee of Terayon's Board of Directors are working  
25 closely with the company's independent auditors in connection with the accounting  
26 review. In addition, the Audit Committee has decided to conduct an independent  
27 inquiry into the circumstances relating to the accounting treatment of certain of the  
28 transactions at issue with the assistance of independent legal counsel. The timing and  
possible outcome of the Audit Committee's inquiry cannot be predicted at this time.  
[Emphasis added.]

227. The November 7, 2006 release was false and misleading when made because it  
continued to conceal the true, adverse facts – known but concealed by defendants – that the  
Company's financial problems were not limited to issues regarding the improper recording of  
revenue relating to a single customer for two quarters in 2004 but rather sweeping issues relating to  
a need to restate the financials for nearly the entire Class Period and massive, overarching internal  
control problems.

228. As a result of defendants' failure to file the Company's quarterly Form 10-Q report,  
with the SEC within the prescribed time, on November 22, 2006, Terayon announced that it had  
received a letter from the Nasdaq Stock Market notifying the Company that Terayon's stock was

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1 subject of delisting (for violation of Rule 4310(c)(14), that requires the timely filing of periodic  
2 reports with the SEC). Also, as a result of defendants' failures to make a timely Form 10-Q filing  
3 with the SEC, Terayon's trading symbol was changed to "TERNE" from "TERN," on or about  
4 November 21, 2005.

5 229. The Company's November 22, 2005 release also stated, in part, the following:

6 Terayon announced on November 7, 2005 its delay in filing the Form 10-Q as the  
7 company is reviewing the recognition of revenue for certain transactions during prior  
8 periods. Terayon initiated the review after determining that certain revenues  
9 recognized in the second half of fiscal year 2004 from a customer may have been  
10 recorded in incorrect periods. The revenue matters under examination relate to the  
11 timing of revenue recognition and may result in a restatement of prior period  
12 financials. Terayon cannot determine at this time when the investigation will be  
13 completed, but the company intends to file its Form 10-Q for the third quarter of  
14 2005 as soon as practicable following the conclusion of the investigation. The SEC  
15 has informed Terayon that it has initiated an informal inquiry into the matters  
16 discussed in the November 7, 2005 press release. Terayon intends to cooperate fully  
17 with the SEC's inquiry.

18 230. On January 10 2006, defendants published a release that provided a purported  
19 "update" on the Company's continuing accounting review, also announcing that Terayon had  
20 received a letter from the Nasdaq stating that the Commission had already begun investigating:

21 **Terayon Provides Update on Accounting Review**

22 Company Also Receives Letter from NASDAQ Regarding its 2005 Shareholder  
23 Meeting

24 Terayon Communication Systems, Inc. (NASDAQ: TERNE), a leading provider of  
25 digital video networking applications and home access solutions, announced on  
26 November 7, 2005 that the filing of its Form 10-Q for the third quarter of 2005  
27 would be delayed and that it had commenced an accounting review after determining  
28 that certain revenues recognized in the second half of fiscal year 2004 may have been  
recorded in incorrect periods. The delayed filing of Terayon's Form 10-Q for the  
third quarter of 2005 caused Terayon to be in violation of NASDAQ Marketplace  
Rule 4310(c)(14), which requires the timely filing of periodic reports with the U.S.  
Securities and Exchange Commission (SEC). While steady progress has been made,  
Terayon cannot determine at this time when the accounting review will be  
completed. The company intends to file its Form 10-Q for the third quarter of 2005  
as soon as practicable following the conclusion of the accounting review.

*In addition, as a result of the delay in the filing of its Form 10-Q for the quarterly  
period ended September 30, 2005, Terayon is not in compliance with its obligation  
under the Indenture with respect to Terayon's 5% Convertible Subordinated Notes  
due 2007 (Notes) to file with the SEC and the trustee of the Notes (Trustee) all  
reports, information and other documents required pursuant to Sections 13 or*



1 *15(d) of the Securities Exchange Act of 1934. If holders of at least 25% in*  
 2 *aggregate principal amount of the Notes outstanding provide written notice to the*  
 3 *Trustee or to Terayon and the Trustee of a default based on Terayon's failure to*  
 4 *file its Form 10-Q Report for the quarterly period ended September 30, 2005 and*  
 5 *such default is not cured within 60 days of such notice, an event of default will*  
 6 *occur and the Trustee or holders of at least 25% in aggregate principal amount of*  
 7 *the Notes then outstanding may accelerate the maturity of the Notes and declare*  
 8 *the entire principal amount of the Notes, together with all accrued and unpaid*  
 9 *interest thereon, to be due and payable immediately. The Notes currently*  
 10 *outstanding have an aggregate principal amount of \$65 million. The company*  
 11 *ended 2005 with \$101 million of Cash and cash equivalents plus Short-term*  
 12 *investments. [Emphasis added].*

13 231. The Company's January 10, 2006 release also provided a purported "Update" on  
 14 Terayon's trading status on the Nasdaq, in part, as follows:

#### 15 **NASDAQ Update**

16 Terayon also announced today that it received a letter from The Nasdaq Stock  
 17 Market (NASDAQ), dated January 4, 2006, notifying the company that its common  
 18 stock is subject to delisting based on its failure to satisfy NASDAQ Marketplace  
 19 Rules 4350(e) and 4350(g), which required the company to solicit proxies and hold  
 20 an annual meeting of shareholders before December 31, 2005. Terayon held its 2004  
 21 annual shareholder meeting in December 2004 and the company's 2005 annual  
 22 shareholder meeting was originally planned for December 2005. However, Terayon  
 23 was unable to hold its 2005 annual shareholder meeting due in part to its ongoing  
 24 accounting review.

25 As previously disclosed on November 22, 2005, Terayon received a letter from  
 26 NASDAQ, dated November 17, 2005, stating that as a result of Terayon's failure to  
 27 timely file its Form 10-Q for the third quarter of 2005 with the SEC, Terayon's  
 28 common stock is subject to delisting from the NASDAQ National Market. In  
 response to the November 17, 2005 letter, Terayon requested a hearing with a  
 NASDAQ Listing Qualifications Panel which automatically stayed the delisting  
 action pending the issuance of a written decision from the Panel. Terayon presented  
 its plan to evidence compliance with all NASDAQ listing criteria at a hearing before  
 the Panel on December 15, 2005. Terayon has not yet received a determination from  
 the Panel as a result of the hearing.

In NASDAQ's January 4, 2006 letter, Terayon was informed that the Panel will  
 consider the company's failure to comply with NASDAQ's proxy solicitation and  
 annual meeting requirements in rendering its decision regarding the continued listing  
 of Terayon's common stock. Terayon discussed the proxy solicitation and annual  
 meeting deficiencies with the Panel at the hearing on December 15, 2005 and plans  
 to submit additional materials for the Panel's review with respect to those issues by  
 the January 11, 2006 deadline. There can be no assurance that the Panel will grant the  
 company's request for the continued listing of its common stock on the NASDAQ.

1           232. The same day, January 10, 2006, the *San Jose Business Journal* reported that  
2 defendants had warned of a possible \$65 million bond default. According to this report, the  
3 Company had stated that the delays in filing its financials may put it in default on \$65 million in  
4 bonds. As a result of this default, the Company's **5% Convertible Subordinated Notes due in**  
5 **2007 become immediately payable if holders of at least 25% of the aggregate principal amount**  
6 **of the bonds provide written notice of a default that isn't cured within 60 days. Days later, on**  
7 **January 13, 2006, Terayon was served with notice of default from holders of over 25% of the**  
8 **outstanding Convertible Subordinated Notes.**

9           233. On January 26, 2006, defendants announced yet another purported "restructuring" –  
10 this time as a "pure play digital video company." That day, Terayon published another release that  
11 stated, in part, the following:

12           **Terayon Restructures to Pure-Play Digital Video Company**

13           Terayon Communication Systems, Inc. (NASDAQ: TERNE), a leading provider of  
14 video localization-on-demand solutions, today announced a restructuring to focus the  
15 company's strategy solely on its digital video applications and reduce its overall cost  
16 structure as a pure-play video business.

17           *"Our decision to concentrate solely on digital video applications enables us to*  
18 *laser-focus the company on a growing market for real-time network digital video*  
19 *processing and expand our applications and services,"* said Jerry Chase, Terayon,  
20 CEO. "Network operators worldwide in cable, satellite, telco and mobile, understand  
21 that they must customize digital video programming services and advertising  
22 to become more relevant to their individual customers. The move to customizing  
23 content delivered the instant before viewing creates substantial opportunity for  
24 Terayon, particularly in the area of digital video advertising, as it builds on our  
25 existing core competencies and market leadership. Localizing services and  
26 advertising plays strongly to the core strength exhibited in our award winning  
27 CherryPicker® product line."

28           As part of the company's move to a pure-play video business, Terayon is reviewing  
strategic alternatives for its Home Access Solutions product line including the  
opportunity to monetize its current investment in working capital. As part of the  
restructuring, Terayon expects to record charges of approximately \$0.6 million for  
employee related costs in addition to other restructuring costs, the majority of which  
are expected to occur in the first quarter of 2006.

          Chase continued, **"We are now structured to take advantage of what we do best.** By  
focusing on digital video, we expect to drive our strategic goals of increased market  
penetration and improved financial performance. With the savings we obtain from  
the restructuring, we intend to allocate additional resources for digital video software  
application development to pursue new revenue-generating video opportunities.

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1 Through our focus and partnerships with key industry players and existing customer  
 2 relationships in the cable, satellite and telco markets, ***Terayon is well positioned for  
 success.*** [Emphasis added.]

3 234. The January 26, 2006 release was false and misleading because the restructuring  
 4 move did not make the Company "well positioned for success" but was actually a last-ditch effort to  
 5 spin a very negative situation quickly enveloping all aspects of the company – from financials, to  
 6 internal controls, to performance and results – in a positive light despite the true fact that defendants  
 7 well knew that massive financial and accounting improprieties were severely undermining the  
 8 Company and its ability to function prospectively, and a massive restatement was both unavoidable  
 9 and imminent.

10 **THE TRUE FINANCIAL AND OPERATIONAL**  
 11 **CONDITION OF TERAYON IS BELATEDLY DISCLOSED**

12 235. On March 1, 2006, the last day of the Class Period, defendants finally revealed to  
 13 investors the secret truth behind that Company's reported purported successes: still more financial  
 14 and accounting improprieties! That day, defendants published a release announcing that the Audit  
 15 Committee of the Board of Directors of the Company had revealed that defendants artificially  
 16 inflated the Company's financial results in the prior periods and it concluded that ***Terayon's***  
 17 ***consolidated financial statements for the year ended December 31, 2004 and the first two***  
 18 ***quarters of 2005 should no longer be relied upon and would be restated.*** This release stated, in  
 19 part, the following:

20 **Terayon Announces Expected Restatement of Prior Periods**

21 Terayon Communication Systems, Inc. (NASDAQ: TERNE) today announced that  
 22 the Audit Committee of the Board of Directors has concluded that the Company's  
 23 consolidated financial statements for the year ended December 31, 2004 and for the  
 24 four quarters of 2004 and the first two quarters of 2005 should no longer be relied  
 25 upon and will be restated. This conclusion was based in part on the final results of  
 the previously announced Audit Committee inquiry. The inquiry focused on the  
 circumstances surrounding the timing of revenue recognition in the second half of  
 2004 from a customer of the Company ....

26 \* \* \*

27 The Company has also reviewed its revenue recognition policies relating to the  
 28 recognition of the sales of software and other products bundled with post customer  
 service contracts and has considered the guidance under SOP 97-2, Financial  
 Accounting Standards Board Technical Bulletin 90-1, "Accounting for Separately



**TERAYON PRICES OCTOBER 18, 2005—NOVEMBER 8, 2005**

<b><u>Date</u></b>	<b><u>Open</u></b>	<b><u>High</u></b>	<b><u>Low</u></b>	<b><u>Close</u></b>	<b><u>Volume</u></b>
8-Nov-05	\$2.37	\$2.37	\$2.17	\$2.25	2,538,400
7-Nov-05	\$2.40	\$2.61	\$2.36	\$2.57	903,400
4-Nov-05	\$2.58	\$2.62	\$2.36	\$2.36	666,100
3-Nov-05	\$2.60	\$2.66	\$2.53	\$2.59	497,900
2-Nov-05	\$2.59	\$2.59	\$2.53	\$2.58	406,700
1-Nov-05	\$2.67	\$2.68	\$2.53	\$2.57	696,300
31-Oct-05	\$2.59	\$2.69	\$2.57	\$2.69	748,700
28-Oct-05	\$2.39	\$2.65	\$2.38	\$2.65	1,592,400
27-Oct-05	\$2.66	\$2.66	\$2.38	\$2.39	2,135,600
26-Oct-05	\$2.95	\$2.95	\$2.55	\$2.64	1,572,100
25-Oct-05	\$2.93	\$2.95	\$2.74	\$2.94	882,200
24-Oct-05	\$3.05	\$3.10	\$2.89	\$2.95	828,800
21-Oct-05	\$3.14	\$3.20	\$3.03	\$3.05	552,100
20-Oct-05	\$3.27	\$3.33	\$3.14	\$3.14	237,600
19-Oct-05	\$3.20	\$3.29	\$3.00	\$3.26	819,200
18-Oct-05	\$3.47	\$3.50	\$3.22	\$3.22	792,900

SOURCE: Yahoo Finance

**TERAYON PRICES JANUARY 9, 2006—JANUARY 17, 2006**

<b><u>Date</u></b>	<b><u>Open</u></b>	<b><u>High</u></b>	<b><u>Low</u></b>	<b><u>Close</u></b>	<b><u>Volume</u></b>
17-Jan-06	\$1.87	\$1.92	\$1.63	\$1.75	2,152,300
13-Jan-06	\$1.99	\$1.99	\$1.86	\$1.91	2,421,300
12-Jan-06	\$2.00	\$2.01	\$1.94	\$1.97	568,800
11-Jan-06	\$2.00	\$2.05	\$1.83	\$2.00	2,454,700
10-Jan-06	\$2.10	\$2.13	\$2.02	\$2.06	713,100
9-Jan-06	\$2.07	\$2.13	\$2.07	\$2.13	232,900

SOURCE: Yahoo Finance

**TERAYON PRICES MARCH 1, 2006—MARCH 2, 2006**

<b><u>Date</u></b>	<b><u>Open</u></b>	<b><u>High</u></b>	<b><u>Low</u></b>	<b><u>Close</u></b>	<b><u>Volume</u></b>
2-Mar-06	\$2.25	\$2.61	\$2.16	\$2.33	4,873,200
1-Mar-06	\$2.66	\$2.82	\$2.66	\$2.70	641,100

SOURCE: Yahoo Finance